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The Journal of Public Policy in perspective

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ABSTRACT

In this final JPP issue from the Centre for the Study of Public Policy, I review its distinctive aim of publishing articles applying relevant concepts from the social sciences to problems facing contemporary governments. The aim is illustrated by reprinting five articles from past issues and a Symposium (1986) discussing different ways in which social science journals are edited. The articles are Bowen (1982); Weaver (1986); Rose (2002); Silvia (2004); Bruner and Abdelal (2005).

Key words: *Journal of Public Policy, journal reviewing, EU politics, blame-sharing, implementation*

Political events in the late 1960s and interdisciplinary developments encouraged academic disciplines to return to their roots and be social as well as scientific. Public policy schools were founded at Harvard and Berkeley to build bridges between problems found in journal articles published in the separate disciplines of economics, political science and sociology and the "undisciplined" problems in the In trays of government departments. They are best understood by applying a tool kit of concepts and methods from across the social sciences (Rose 1976).

In recognition of the intellectual and practical advantages of combining social science and public policy, I founded the Centre for the Study of Public Policy at the University of Strathclyde in 1976. It was the first University-based public policy centre in a European university. Five years later the Journal of Public Policy was launched with Cambridge University Press to provide an outlet for social scientists whose research applied generic concepts to real existing problems of public policy. Since new editors will take over with the next issue, it is appropriate to look back on what has been accomplished since then.

The JPP's aim is to promote the use of relevant concepts from any of the social sciences to analyse significant problems facing contemporary governments. Good ideas recognise neither geographical nor national boundaries. Path-breaking ideas in institutional economics have come from examining 17th-century religious groups in England and the understanding of contemporary societies has been advanced by studies of urban politics in

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Chicago and Oakland, California. In keeping with its commitment to openness, the journal seeks reviews from social scientists in more than a dozen disciplines and countries (see this issue, pp. 409–411). Every article is read by reviewers in more than one country and often two continents. Reviewers for such interdisciplinary topics as social or environmental policy are chosen on the basis of their expertise without regard to the department in which they are based. Reviewers in intergovernmental organizations have a professional interest in substantive significance. Members of the editorial board have been presidents of the International Institute of Public Finance as well as of the American Political Science Association. Whatever its limitations, the JPP cannot be accused of travelling along the tramways of a single academic discipline.

The proliferation of social science journals reflects differences in both their aims and audiences. These are brought out in the mini-symposium on Editing a Journal reprinted below. Charles Jones contrasts editing a general journal, the American Political Science Review, and a specialist journal, the Legislative Studies Quarterly. The former resembles the task of a University president having to make judgments about academics whose expertise is remote from their own whereas the editors of specialist journals can make peer judgments because they are familiar with the field their journal is about. Chester Newland's account of the Public Administration Review shows that the tension between practitioners and academics is perennial, but alters when governments promote private sector values and management techniques and nostrums.

The JPP has never been subject to pressures from professional associations or practitioners. The insistence that generic concepts and methods should be related to problems that are public gives it a distinctive position vis a vis publications concentrating on abstract theories and equations that, unlike a model of an automobile engine, cannot be related to the world as it actually is. In addition to responding to submissions on their own terms, the JPP has also been ready to initiate symposia and special issues arising from collaboration between trans-national groups of social scientists (see e.g. Symposium, 1989). The time needed to publish an academic journal means that articles are assessed for their durable value rather than for their immediate (and potentially transitory) relevance to discussions in op-ed pages of newspapers.

This final issue under the CSPP banner presents some things old and some things new. The new articles reflect the JPP's continuing interest in the transmission of ideas across boundaries, as reflected in the development of the European Union as a public policy actor and in reforms of institutions as traditionally national as the French prefect system started under Napoleon. From an embarrassment of choices, five articles are reprinted. Two from the 1980s show that good ideas are durable across generations.

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Elinor Bowen rigorously applies statistical logic to demonstrate that the many steps to implement a policy that Pressman and Wildavsky (1973) identified are obstacles that can be overcome when the steps are interdependent. Kent Weaver authored the pioneering examination of how politicians avoid blame when the policies that they implement go wrong.

The plight of the eurozone today makes painfully topical the JPP's continuing interest in political economy. A special issue on currency choices in an interdependent world, edited by Artis and Rose (2002), compared the foreign exchange policies of countries outside the euro, such as Switzerland and Sweden, with countries committed to the eurozone. My conclusion shows how a POP (Politically Optimal Policy) differs from theories of an Optimal Currency Area. The implications of sub-optimal inflexibility in the eurozone are analyzed by Stephen Silvia's 2004 contribution. The article on the role of credit-rating agencies in judging Leviathan by Christopher Bruner and Rawi Abdelal raised issues in 2005 that governments cannot hide from today.

Although the JPP has never been in thrall to quantified metrics, it is right to draw attention to articles most often downloaded or cited in the past year. The durability of ideas is demonstrated by their publication in three different decades. The most downloaded articles are: Paul Sabatier (1986), "Top-Down and Bottom-Up Approaches to Implementation Research"; Giandomenico Majone (1997), "From the Positive to the Regulatory State", and Adrienne Héritier and Dirk Lehmkuhl, (2008), "The Shadow of Hierarchy and New Modes of Governance". The list of most cited articles includes Kent Weaver's article reprinted herein; "What Is Lesson-Drawing" by Rose (1991); "Iron Triangles, Woolly Corporatism and Elastic Nets" by Grant Jordan (1981); and Michael Foley and Bob Edwards' (2000) "Is It Time to Disinvest in Social Capital?"

Over the decades hundreds of social scientists in universities, think tanks and intergovernmental organizations have freely given their time to the anonymous task of reviewing articles. The JPP has reduced the burden by having an instant rejection policy for submissions that, whatever may be their merits, are unsuitable for an international social science publication for reasons of subject matter, length or style. This has made it possible for reviewers and editors to devote more time to submissions that could, with significant effort, be turned into interesting and clearly written publishable articles. In the early years of the journal a significant contribution was made by Dr. Brian Hogwood, formerly of Cambridge University Press and Strathclyde. Edward C. Page, first at Hull and now at the London School of Economics, has served as book review editor and then co-editor. Within the CSPP Isobel Rogerson kept meticulous track of correspondence in the days when communication was on paper, and Ohna J. Robertson has done so in an electronic era. Appreciation is due to everyone – and best wishes to the new editors, Peter John at University College, London and Anthony Bertelli at the University of Southern California.

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Artis Michael and Richard Rose (2002) Currency Choices in an Interdependent World. *A special issue of the Journal of Public Policy* 22(2): 107–260.

Foley Michael and Bob Edwards (1999) Is It Time to Disinvest in Social Capital? *Journal of Public Policy* 19(2): 141–173.

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Appendix

The following articles, all reprinted from JPP's rich backlist, focus on some of the key themes that have dominated past issues, yet remain durable and relevant today.

Bowen, Elinor R., (1982) "The Pressman-Wildavsky Paradox: Four Addenda or Why Models Based on Probability Theory Can Predict Implementation Success and Suggest Useful Tactical Advice for Implementers", Journal of Public Policy, 2 (1): 1-22.

Weaver, R. Kent, (1986) "The Politics of Blame Avoidance", Journal of Public Policy, 6 (4): 371-398.

Rose, Richard, (2002) "Putting Monetary Policy in its Political Place" Journal of Public Policy, 22 (2): 257-269.

Silvia, Stephen J. (2004) "Is the Euro Working? The Euro and European Labour Markets", Journal of Public Policy, 24 (2): 147-168.

Bruner, Christopher M. Bruner and Rawi Abdelal, (2005) "To Judge Leviathan: Sovereign Credit Ratings, National Law and the World Economy", Journal of Public Policy, 25 (2): 191-217.

Symposium: Editing a Journal (1986). Charles O. Jones, "On Being an Editor Twice"; Chester A. Newland, "PAR: A Professional Journal for Practitioners and Academicians", and Richard Rose, "Editing an International Interdisciplinary Journal", 6 (1): 113-119

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The Pressman-Wildavsky Paradox: Four Addenda or Why Models Based on Probability Theory Can Predict Implementation Success and Suggest Useful Tactical Advice for Implementers

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ABSTRACT

Pressman and Wildavsky's *Implementation* occupies center stage in the developing literature about policy implementation, in part because of the analogy they drew between implementation processes and the multiplicative model from probability theory. This paper takes the relevance of probability theory further and considers the additive model from probability theory and conditional probabilities as well as the multiplicative model. This expanded coverage of probability theorems (1) leads to markedly increased optimism about the likelihood of successful implementation, (2) encompasses empirically reasonable tactics such as persistence, packaging of clearances, engineering bandwagons and policy reduction, and (3) generates advice to hopeful implementers – some of it non-obvious.

It is commonplace to state that bargaining lies at the heart of political processes, familiar to note that mathematical analogs to phenomena afford distinct advantages, and hardly original to note that game theory is the most appropriate mathematical model for situations where outcomes depend on the actions of two (or more) bargainers. Unfortunately, the games which are analogous to interesting political phenomena are frequently too complex to permit mathematical solutions (Schelling, 1960). This paper is about a more limited kind of bargaining – generally called policy implementation strategy – and its conjunction with a simpler and more readily soluble mathematical calculus, that of probability theory.

The idea that probability theory can be linked to implementation processes

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is not a new one and was originally advanced by Jeffrey Pressman and Aaron Wildavsky in their classic (1973) study of an Economic Development Agency project in Oakland, California. Those authors used the multiplicative model from probability theory to underscore their point that the 'complexity of joint action' leads to extremely poor chances of policy implementation. They do not explore the relevance of probability theory to implementation bargaining further, and while their argument about the complexity of joint action has been influential in the developing literature on implementation, no other author has chosen to further develop their insight about the relevance of probability theory. This paper is an attempt to do so, and will build on Pressman and Wildavsky's insight in several ways. Perhaps the major departure in this paper from Pressman and Wildavsky's use of probability theory is that it is used to explain (and predict) implementation success and to offer advice to hopeful implementers, whereas Pressman and Wildavsky have used it to support a point about implementation failure. Further, this paper considers the multiplicative model from probability theory, the additive model from probability theory and conditional probabilities, whereas Pressman and Wildavsky considered only the multiplicative model.[1]

Implementation as bargaining

Political science as a discipline has long had a preference for the use of conflict models rather than consensual models, a tendency toward reductionism rather than wholism, and a relative indifference toward the distinction between authority and other forms of power. It is not surprising, then, that studies of policy implementation in bureaucracies done by political scientists depart in major ways from the classical, or Weberian, model of bureaucracy.[2]

A growing list of implementation studies done by political scientists has treated policy implementation in a way which assumes conflict, treats consensus as exceptional, reduces bureaucracy to smaller units of individuals or groups in conflict, and replaces compliance based on legal/rational authority with a political or bargaining model.[3] Perhaps the first of this genre was Neustadt's *Presidential Power* (1980) which told us that even for an administrator as strong as the President of the United States, power was the ability to persuade rather than to command, or, in a vocabulary which postdates Neustadt, policy implementation is abnormal and noncompliance what is to be expected. Subsequent implementation studies found failed programs under conditions where one would have expected success, and strengthened the case for viewing public policy implementation as a bargaining process (Derthick, 1972; Bailey and Mosher, 1968; Gross, Giancquinta and Bernstein, 1971; Orfield, 1969; Lambright, 1967; Pressman and Wildavsky, 1973). Eventually, the expectation of conflict rather than

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cooperation became so well established that successful implementation, rather than failure, was viewed as anomalous. For example, Bardach (1977) presents a case study of a partially implemented mental health policy in California and finds even its partial implementation so surprising that it requires explanation – in this case the intervention of a powerful state legislator with an intense commitment to the policy who intervened as a 'fixer' on its behalf on several occasions.

Most of these implementation studies concern programs which are intergovernmental or intra-agency in nature, thus the 'command and control' mode and automatic compliance of subordinates with the instructions of superiors which Weber, and others, have taken as the hallmark of bureaucracy, are not applicable. But even if implementation were to be undertaken within one organization, it is likely that analysis by political scientists would stress conflict and bargaining rather than the legal/rational mode of interaction. Indeed, Pressman and Wildavsky's use of the multiplicative model from probability theory leads to predictions of failure in all multi-stage implementation scenarios, even when the odds associated with success at each stage are high.

Implementation as asymmetrical bargaining in an open system

For probability theory rather than game theory to be relevant to implementation processes, it must be the case that implementation resembles a 'game against nature' more than it resembles a bargaining session among two (or more) players. This is the case for implementation processes for at least two reasons. First, while policy development in legislatures frequently involves continuing conflict between two (or more) opposing groups, the implementation of programs in bureaucracies, as described in the literature, is asymmetrical in that it involves a consistently active implementer on the one hand and opponents who intervene on an intermittent basis.

Indifference and inertia are reported as barriers to implementation at least as frequently as is more active opposition. Second, implementation processes are, from the perspective of the typical implementer, open systems. As Pressman and Wildavsky document in their case study, programs which are launched with no visible opposition face interference from unexpected quarters. Persons supportive of a program resign and are replaced. Lines of authority within bureaucracies are changed. Priorities of agency superiors fluctuate. Agreements are reneged upon. Bardach (1977) suggests in an appendix that implementers try to identify the systems relevant to implementation by enumerating all resources needed for implementation and identifying those persons or groups in control of relevant resources. But even when this useful strategem is followed, unforeseen contingencies may require unanticipated resources and controllers of resources may change over time.

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Game theory is relevant to situations in which the actors whose 'moves' determine outcomes can be identified in advance and assigned preferences. This is not usually possible in implementation scenarios, especially when they extend over considerable periods of time.

The Pressman – Wildavsky paradox

Pressman and Wildavsky's book about policy implementation difficulties has an intriguing title and a provocative message. The title: *Implementation: How Great Expectations In Washington Are Dashed In Oakland; Or, Why It's Amazing That Federal Programs Work At All, This Being A Saga Of The Economic Development Administration As Told By Two Sympathetic Observers Who Seek To Build Morals On A Foundation Of Ruined Hopes*, is one on which I cannot improve. The provocative message is that even when actors in the policy implementation process initially agree to cooperate in order to achieve mutually compatible objectives, the existence of multiple decision points requiring multiple 'clearances' from various of the actors can defeat implementation. This message, or lesson, is drawn from a case study of an EDA program in Oakland, California.

The EDA allocated some $23,000,000 to Oakland, most of which was to be spent by the Oakland Port Authority to construct a hangar and terminal. The construction was to involve minority workers and the hangar was to be leased to a private corporation, World Airways, which would employ minority workers in its expanded operation. The Port Authority was an experienced grant recipient, wanted the facilities constructed, and was willing to lease to World Airways. World Airways wanted the hangar, was offered it on favorable terms, and agreed to employ minority workers in exchange. Various city fathers blessed the proposed arrangement and pledged their support. No significant opposition groups existed or were formed. Nonetheless, implementation took four and a half years and was only partially successful.

Pressman and Wildavsky accompany their case study materials with a probabilistic model which gives a wider applicability to their pessimistic conclusion about the likelihood of implementation for federal programs. Pressman and Wildavsky do not offer extensive development of their insight that probability theorems are isomorphic with implementation scenarios. However, the seeming power and pessimism of the multiplicative model from probability theory which they suggest renders the successful implementations of any program paradoxical.

The Pressman – Wildavsky paradox is most succinctly presented in Table 1 below. The calculations are based on the multiplicative model of ordinary probability theory such that the relevant formula for calculating the likelihood of implementation is

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$$P\ (A\ \&\ B\ \&\ C\ldots) = P(A)\ P(B)\ P(C)\ldots$$ [4]

TABLE 1. *The Pressman-Wildavsky Paradox**

Probability of agreement on each clearance point	Probability of success after 70 clearances	No. of agreements that reduce probability below 50 per cent
.80	.000000164549	4
.90	.000626577	7
.95	.0275837	14
.99	.494839	69
.999	.9324	693

* Adapted from Pressman and Wildavsky (1973) p. 107. The figures shown in column 2 are slightly different from the original, but do not change the original authors' point. The fifth row has been added.

The multiplicative model of probability theory is relevant to policy implementation when

(1) a number of clearances are necessary for a program to be implemented,
(2) these clearances are best conceptualized as statistically independent,
(3) the clearances can be typed as 'yes' or 'no' responses which are mutually exclusive,
(4) the full set of clearances is necessary for implementation, and
(5) the order in which clearances are gained is not important.

Pressman and Wildavsky argue that their case study is isomorphic with these assumptions, and add the simplifying assumption that the probability of obtaining each clearance is equal. Thus the figures which appear in Table 1 are based on the use of the simplified formula

$$P\ (A\&B\&C\ldots\ldots) = P(A)^n$$

where P represents the probability of a single 'success' (.80, .90, .95 or .99 in the Pressman-Wildavsky example) and n equals the number of successes required (70 in their example). Thus the probability of successful implementation with favorable odds of .80 for each clearance would be $.80^{70}$, and that number is within rounding distance of zero. As Pressman and Wildavsky point out, quibbling over the number of clearances required in Oakland is not worthwhile since a markedly smaller number would also have resulted in zero probability of implementation if the other assumptions are accepted. Once the five assumptions about clearances and implementation enumerated above are accepted, EDA's Oakland experience is isomorphic with a powerful probability calculus which leads to an invidious conclusion.

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A first addendum: persistence

Let us begin by accepting the assumptions stated above as reasonable but incomplete, and let us add a persistence factor such that more than one attempt at obtaining each clearance will be made by implementers. The case for this addition seems a strong one since administrators are often reported to try and try again. It may even be the case that a single attempt to gain compliance is never sufficient and that all implemented programs have involved multiple attempts to gain clearances. For example, Neustadt (1980, 109) quotes a member of Franklin Roosevelt's Cabinet as stating that he regularly ignored the President's first suggestion to take an action, tended to ignore the second, and partially complied only upon the third request.[5]

Most of us learned probability theory through illustrations about flipping coins, and that tradition provides a starting point for examining the impact of the persistence factor on implementation. Pressman and Wildavsky have told us, in effect, that if we were to flip a dishonest coin (that is, one which came up 'heads' eighty, ninety, or ninety-five percent of the time) the chances of our obtaining a run of heads in a series of seventy tosses is negligible. It would be. But let us imagine a different kind of coin-flipping game, one in which one had to produce a series of heads but had several tries in each instance. At each clearance point, then, implementers would have several chances to gain agreement. Using an honest coin (that is, one in which heads and tails are equally probable) and three tosses, probability theory tells us that our chances of obtaining at least one head are 7:8 since we are now dealing with a combination where the addition rule of probability theory applies such that the relevant formula would be

$$P\ (A \text{ or } B \text{ or } C\ldots) = P(A) + P(B) + P(C) - P(A\&B) - P(A\&C) - P(B\&C) + P(A\&B\&C)\ldots$$

If one makes the simplifying assumption that all probabilities for one success are equal, the formula becomes

$$P\ (A \text{ or } B \text{ or } C\ldots) = 1 - P(A)^n$$

where n = number of tries, and P = probability of one success.

With biased coins, such as the ones Pressman and Wildavsky thought were associated with the probabilities for individual clearances in Oakland, the prognosis for implementation would be quite favorable. Pressman and Wildavsky (1973, 108) noted that 'one must advance to the 99 percent level of concurrence, an extraordinary state of affairs by any calculation' in order for program implementation to be probable. But my calculations show that a .99 percent chance of implementation, and better, can readily be achieved so long as implementers make repeated tries to gain each needed clearance.

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As illustrated in Table 2, persistence has a dramatic effect on the prognosis for implementation. Indeed, under conditions of initial uncertainty, as represented by the toss of an honest coin, the probability of at least one success after ten tosses is .999 and the chance of seventy such successes ($.999^{70}$) is .9324 – results which are very likely too optimistic. Persistence, then, is both a promising explanation for implementation success and, if they were not already aware of its possibilities, useful advice to hopeful implementers.

TABLE 2. *The Pressman-Wildavsky paradox with persistence factor added*

Initial probability of agreement at one clearance point	Probability of agreement after			
	2 Tries	3 Tries	5 Tries	10 Tries
.10	.190	.271	.410	.651
.20	.360	.488	.672	.893
.30	.510	.657	.832	.973
.40	.640	.764	.922	.994
.50	.750	.875	.969	.999
.60	.840	.936	.990	.999+
.70	.910	.973	.998	.999+
.80	.960	.992	.999+	.999+
.90	.990	.999+	.999+	.999+

Persistence on the part of implementers, however, is not without cost. One kind of resource consumed by persistence, albeit not the only kind, is time. If we consider time as a resource, the persistence addendum can account for delay in implementation. The optimistic prognosis mentioned above concerns eventual implementation. If we assume, in admittedly arbitrary fashion, that each attempt to gain a clearance takes two weeks, and that ten attempts are undertaken at each of seventy decision points, it follows that program implementation can be virtually guaranteed when the odds at each clearance are .5 – but this would take more than twenty-six years to accomplish. This degree of persistence must be rare, but some more reasonable projections are shown in Table 3.

These figures show that, for example, an implementer initially confronted by a .9 chance of agreement can virtually guarantee successful implementation with two attempts at each clearance, a process which would require about five years. An implementer facing initial odds of agreement of .7, however, would achieve zero chance of implementation after investing the same time and effort. It would take this implementer a generation to guarantee implementation. An implementer facing initial odds of agreement of .4 would achieve .6541 odds of complete implementation after a generation's effort, and implementers facing lesser initial probabilities than these fare even less well. The assumption that an attempt at a clearance

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TABLE 3. *Certainty versus timeliness in an implementation scenario with persistence*

Initial probability of agreement at each clearance point	No. attempts to gain each clearance	Probability of success after 70 clearances	Time required for success (2 weeks per attempt)
·4	5	.000	750 weeks
·4	10	.654	1,400 weeks
·5	5	.108	700 weeks
·5	10	.932	1,400 weeks
·7	2	.003	140 weeks
·7	5	.147	750 weeks
·7	10	.999+	1,400 weeks
·9	1	.001	140 weeks
·9	2	.932	280 weeks

takes two weeks is, of course, arbitrary and, probably, variable as well in that time is a function of the scale of an agency and of the stature of an agency's negotiating representative. But the two week estimate is consonant with those made by Pressman and Wildavsky and, for the first time, we have arrived at predictions from the model which seem empirically reasonable.

A second addendum: packaging of clearances

Once one leaves Weberian bureaucracies behind, one is likely to assume that compliance with directives is the result of negotiation between superiors and subordinates who are to a significant degree independent actors. Where policy implementation requires coordination or compliance which is inter-agency in its nature, as in the EDA program in Oakland or the California mental health program described by Bardach, the case for the independence of actors from whom clearances are needed is yet stronger. But it is important to note that the assumption of independence among clearances made by Pressman and Wildavsky, and required to establish isomorphism between their Oakland implementation study and the probabilistic model used in Table 1, is of a somewhat different nature. That is, Pressman and Wildavsky assume the independence of the seventy clearances required for implementation, not the independence of the approximately twenty actors who entered into negotiations about clearances. I do not wish to ask the reader to forego an assumption of independence among actors. I do question the independence of the clearances.

Let us assume, instead, that the negotiations among independent actors concern packages of clearances such that any given negotiation involves clearances for several program elements. In the Oakland case, this might

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mean that EDA negotiators sought clearances for an employee training program, minority hiring quotas, an affirmative action officer and interim financing simultaneously. An assumption that program elements may be collected in packages or that a multiplicity of clearances may be sought in a single negotiation seems empirically reasonable, although Pressman and Wildavsky do not provide us with sufficient information about negotiations in Oakland to ascertain whether it was the pattern there. The assumption that clearances are negotiated as packages has some analytic advantages as well. If each clearance were sought in isolation, it would be difficult to find a place for familiar phenomena such as log rolling and pork barrel in our bargaining model.

Let us imagine, then, that EDA implementers did sometimes offer to trade more dollars for more jobs or interim financing for affirmative action officers, that World Airways replied in kind, and that these offers and counter-offers were exchanged in a common negotiating session. An assumption that clearances are negotiated in packages has implications for the probabilistic model which is the basis of the Pressman-Wildavsky paradox, since it drastically reduces the number of terms to be multiplied. Thus, for example, if seven clearances were negotiated as a package at each of ten sessions, the probabilities associated with a successful outcome at each round would only have to be raised to the tenth power, a circumstance which would lead to comfortable predictions of success if the initial probabilities were above .95 and, even if each of these complicated sessions required a month for completion, implementation could be negotiated in ten months.

TABLE 4. *The Pressman-Wildavsky paradox with packaging of clearances*

Probability of agreement on each package	Probability of success after 10 packages	Probability of success after 20 packages
.8	.1073742	.0115292
.9	.3486783	.1214763
.95	.5987366	.3584854
.99	.9043818	.8179062
.999	.9900442	.9801877

Pressman and Wildavsky's account of events in Oakland suggests that 18 different combinations of actors, or packages were involved in the various Oakland clearances. Table 4 illustrates the consequences of two degrees of packaging for both the probability of successful implementation and the amount of delay which would be engendered. The figures show that highly favorable initial odds of agreement are needed to insure program implementation, and that the addition of a packaging factor does not affect the

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Pressman-Wildavsky paradox nearly as forcefully as did the addition of a persistence factor, unless the degree of packaging accomplished involved much more aggregation than shown in Table 4. Pressman and Wildavsky may have ignored packaging as a way of improving the chances of implementation since they viewed .95 initial odds as unrealistically high. However, the packaging addendum to their model and the persistence addendum are compatible, and a satisfactory model of the implementation process based on probabilistic reasoning might include both. Provision of both addenda would have its major impact on predictions of delay, as illustrated in Table 5, in that the implementer faced with initial odds of .7 for each of 10 packages of clearances could attain a reasonable chance of implementation in a year and implementers would not have to give up on implementation within two years unless the initial odds of agreement on each of ten packages were below .5.

TABLE 5. *The Pressman-Wildavsky paradox with persistence and packaging*

Initial probability of agreement for each package	No. attempts to gain agreement on each package	Probability of success after 10 packages	Time required for success (2 weeks per attempt)
.4	5	.4451	100 weeks
.5	5	.7280	100 weeks
.6	3	.5161	60 weeks
.7	3	.7606	60 weeks
.8	2	.6648	40 weeks
.9	2	.9044	40 weeks
.95	1	.5987	20 weeks
.99	1	.9044	20 weeks

A third addendum: bandwagons

Another route to modelling implementation processes can be premised on the possibility that the probability of agreement at one clearance point is a function of the result of negotiations at previous clearance points. Following this route, let us assume that there is a dynamic, or bandwagon effect, in implementation processes such that the actual obtaining of an agreement (no matter its probability before attainment) increases the odds of gaining other clearances, while the failure to obtain a clearance decreases the odds associated with subsequent clearances.

The effects of this kind of bandwagon on implementation processes can be examined by abandoning the assumption that events in an implementation process are statistically independent and turning instead to the use of conditional probabilities. The relevant formula to reflect this change would be

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$$P(A \& B \& C\ldots) = P(A)\,P(B/A)\,P(C/B \& A)\ldots$$

where P(A) represents the probability of successfully attaining the first clearance attempted and P(B/A) represents the conditional probability of attaining a second clearance given the results of the first attempted clearance.

A few assumptions, hopefully not unreasonable, provide a basis for illustrating the bandwagon effect. Let us assume, in appropriately tentative fashion, that in an implementation scenario with seventy clearance points, the effect of history is cumulative and continuous such that each clearance obtained increases the probability of obtaining the next by one seventieth until unity is approximated and each failure to obtain a clearance decreases the odds of obtaining the next by one seventieth until zero is approximated.[6] Two results of this particular pattern of conditional probabilities can be seen in Table 6. First, if the bandwagon effect contributes to implementation in the specified increments, it enhances implementation prospects but is not sufficient to guarantee success unless initial probabilities are extremely high. But if bandwagons, at least in some implementation scenarios, contribute a larger multiplier, the import could be substantial. Second, the figures in Table 6 illustrate that only a limited number of clearance points are decisive to implementation: eighteen clearances in the first example and eight in the second.

TABLE 6. *The Pressman-Wildavsky paradox with bandwagon effect (Assumption: each prior success increases odds of next success by 1/70)*

	Probability of agreement for specified clearance	
Clearance 1	.800	.900
Clearance 2	.811	.913
Clearance 3	.823	.926
Clearance 8	.880	.990
Clearance 9	.891	.999+
Clearance 18	.994	.999+
Clearance 19	.999+	.999+
Clearance 70	.999+	.999+
All clearances	.136	.634

The bandwagon addendum has, I think, some other advantages and some non-obvious implications as well. One advantage is that bandwagons can account for the kind of dynamic in attempts to gain compliance which is argued for by Neustadt, among others. Neustadt (1980, 63) quotes Franklin Roosevelt instructing aides to find 'something I can veto' in order to remind Congressmen of his power, and offers the general thesis that Presidential success known to Washington insiders increases the likelihood of future compliance while known failures decrease the likelihood of future

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compliance. Second, bandwagons can account for the dynamic of on-going bureaucratic processes where very high probabilities of continued implementation can be observed because we are looking, in effect, at the thousandth event in an implementation scenario. Another advantage is that the bandwagon addendum suggests interesting tactical advice to hopeful implementers: when the initial probabilities for clearances vary, begin with the most promising; when resources are too limited to allow for persistence at every clearance point, be persistent at the start.

Finally, let us note that while the bandwagon addendum, like the packaging addendum which preceeded it, requires abandonment of the portion of Pressman and Wildavsky's conceptualization of the implementation process in which clearances are independent and its replacement with a conceptualization in which the parties to implementation bargains are independent. This is an analytical advantage in that the independence of actors better corresponds with what has previously been termed the political scientists' preferred approach, and an assumption that actors are independent is sufficient to establish the relevance of the multiplicative model to the original statement of the Pressman-Wildavsky paradox, albeit with an exponent of approximately eighteen rather than seventy.

A fourth addendum: policy reduction

One at least somewhat ironical aspect of the literature we have been considering about the policy implementation process lies in an inconsistent application of reductionist principles. Pressman and Wildavsky, and others, decompose bureaucracy into a large number of independent actors and/or the implementation process into a large number of independent decision-points. In light of this, it is at least surprising that they assume a wholistic posture toward policy.[7]

There are several ways in which the events associated with EDA experiences in Oakland might have been conceptualized. An analyst might have distinguished between program activities and program goals, treating the building of the terminal, the building of the health center, the issuing of loans to small businesses, etc., as program activities designed to reach the overall policy objective of increasing minority employment. If events in Oakland were looked at in this way, the likely conclusion would be that most program activities were eventually implemented but that, unfortunately if not surprisingly, the goal of increasing minority employment was not achieved. This version of the Oakland episode would be recorded as a program design failure rather than an implementation failure.

An alternative conceptualization would reduce the EDA's Oakland policy into a number of independent components, noting, for example, that the terminal might have been completed in the absence of other achieve-

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ments and that the small business loans might have been arranged in the absence of a terminal. Let us suppose, arbitrarily but not unreasonably, that seven independent programs can be identified in Oakland and that implementation of each required ten clearances. The implications of this view of the case study are summarized in Table 7. The implementation probabilities associated with any single, independent program component can be obtained using the multiplicative model which was the basis for the original statement of the Pressman-Wildavsky paradox. Since n now equals 10 rather than 70, the probability of implementation of each program, considered as an independent entity, is somewhat improved. But EDA tried to implement seven small programs in Oakland. To account for this in probabilistic terms, the additive model for events which are not mutually exclusive is relevant. Use of the addition rule yields, of course, a much more favorable prognosis for implementation of at least one program component. As shown in Table 7, an initial probability of .8 for each of ten clearances for each of seven programs yields a probability of .451 of obtaining at least one of these smaller programs or program components.

TABLE 7. *The Pressman-Wildavsky paradox with program reduction (Assumption: seven independent program components, each requiring 10 clearances)*

Initial probability of agreement on each clearance	Probability of implementation for each component	Probability of implementation of at least one component	Probability of complete implementation failure
.6	.006	.042	.958
.7	.028	.181	.819
.8	.107	.451	.549
.9	.349	.950	.050

This seems to provide a more adequate account of EDA's experience in Oakland than did the original multiplicative model since the airport hangar was built and leased, the hangar was completed, and some small business loans were made – evidence of a partial if not a complete implementation success.

In observing implementation processes, we regularly expect that 'something will happen that bears at least a passing resemblance to whatever was mandated by the initial policy decision' (Bardach, 1977, 50). Perhaps the analytic reduction of complex programs into smaller independent subprograms and the use of the additive probability model this entails account for this common expectation that something will occur. The probability model shown in Table 7 would not have allowed a prediction of which of these program components would be implemented, only that the odds of

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achieving nothing whatsoever are, in spite of the complexity of joint action, modest when initial probabilities for clearances are high.

The uses of the program reduction addenda discussed thus far suggest both the predictive advantages of analytically reducing large programs into smaller ones and the wisdom of policy designs which construct larger programs out of separable components. The same reasoning can also be applied to make a case for the strategem of 'throwing resources at problems' by engaging in multiple implementation scenarios. As the number of independent program components for which implementation is attempted increases, the odds that at least one implementation success will be achieved increase as well. Table 8 illustrates this phenomenon for programs whose low probability of implementation renders them 'long shots'.

TABLE 8. *The Pressman-Wildavsky paradox with multiple implementation scenarios: the probability of implementng (at least) one program*

		Number of programs or Scenarios per program				
		2	3	5	10	100
Probability for each program	.1	.190	.271	.410	.651	.999+
Probability for each program	.5	.750	.875	.969	.999	.999+

The attempt at multiple implementation scenarios, whether these are alternative routes to the achievement of the same program or routes to different programs, has the same dramatic effect on the odds of implementation as did the form of persistence discussed earlier. But, of course, unless multiple programs are limited in scope or represent the reduction of a larger program into independent components, this strategem will consume considerable resources and any realistic model of implementation processes should be premised on a recognition that resources are almost always finite and limited.

A probabilistic argument for the ruthless establishment of priorities

When writers interested in implementation difficulties are willing to play Machiavelli to contemporary American implementers, their advice almost always includes a call for focusing limited resources on a limited number of programs. Neustadt (1980), for example, in his commentary on the Carter administration, says that Carter erred in attempting too much at once. Bardach's (1977) recommendation of scenario writing implies a ruthless, and early, abandonment of programs when serious implementation difficulties are anticipated.

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The case for the ruthless establishment of priorities can also be made through an application of the probability theory based models presented in this paper, as illustrated in Table 9. To provide a context for the figures in Table 9, let us imagine a hypothetical implementer with limited resources such that he or she can only enter into negotiations for twenty clearances. The implementer is confronted by three options: (1) he or she can attempt to implement a relatively complex program requiring twenty independent clearances, (2) he or she can attempt implementation of two smaller independent programs, each requiring ten clearances, or (3) he or she can ruthlessly establish priorities and attempt implementation of one small program requiring ten clearances. Only this third option reserves sufficient resources for persistence in the attempt to gain clearances.

TABLE 9. *Probability calculations for an implementer with finite resources (Assumption: resources permit twenty attempts at clearances).*

Options	Probability of (at least) one implementation		
	P for each clearance .7	P for each clearance .8	P for each clearance .9
Pursue one complex policy requiring 20 clearances	.001	.012	.122
Pursue two simpler policies, each requiring 10 clearances	.056	.203	.576
Pursue one simple policy requiring 10 clearances – be persistent	.389	.665	.904

If we make the simplifying assumptions that all bargaining sessions require the same investment of resources and that all initial probabilities for clearances are equal, the model shown in Table 9 is isomorphic with our hypothetical implementer's options. Our advice to the implementer with finite resources is clear: program reduction improves the chances of successful implementation of at least one program, but ruthless adherence to priorities is clearly the strategy to pursue.

Probability theory and other explanations of implementation success

Pressman and Wildavsky deserve considerable credit for introducing the idea that probability theory can be used to model the implementation process. The addenda presented in this paper are, I believe, appropriate extensions of their insight which enhance our ability to use a powerful mathematical calculus to encompass several important, and familiar, aspects of implementation, and other bargaining, processes.

To begin, the addition of a persistence factor to the original model

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subsumes the idea of a 'fixer' as discussed by Bardach (1977) in his implementation study. Under conditions very similar to those which led to a delayed and partial implementation of the EDA program in Oakland, Bardach reports successful implementation after only moderate delay for much of the mental health program which is his focus. Surprised by this outcome, as he must be given his acceptance of Pressman and Wildavsky's main points, he accounts for it by citing the frequent interventions of a powerful and intensely interested member of the Mental Health Committee of the California State Senate. He calls this intervenor a 'fixer', and stresses that implementation would probably not have occurred without him. This fixer, the Bardach case study suggests, operated in two ways to support the program: first, the power of his legislative position influenced compliance, especially on the part of mental health administrators whose other programs were funded by the fixer's Committee. This would be reflected in increased initial probabilities of agreement for anything the fixer supported, and could be given attention in Pressman and Wildavsky's original multiplicative model. But Bardach's case study also recounts a number of instances in which the fixer intervened in the implementation process in ways which constitute multiple attempts to gain clearances. Our model certainly illustrates the importance of persistence of this kind.

Second, the addendum to the original model of a packaging possibility such that clearances for several program elements are sought in a single negotiation makes possible the introduction of two significant and familiar aspects of bargaining into the model: log-rolling and pork barrel. Log-rolling, as it is generally understood, involves the trade of a low priority item which one opposes for a high priority item one supports. Unless at least two items were being negotiated simultaneously, such trading would be impossible. Pork barrel represents a side payment in exchange for a clearance. Since the pork barrel payoff is part of the negotiation, it is again the case that a model which can incorporate this familiar aspect of bargaining must allow for the simultaneous pursuit of multiple clearances. Pressman and Wildavsky have carried the reductionism of their approach to the point where their probability model does not include multi-item agendas at decision points; Bardach's approach is, if anything, more reductionist than theirs. While I have not developed log-rolling and pork barrel for inclusion in my model, I believe that the analytic space which has been left for these additions is an advantage.

Third, timeliness is an important aspect of implementation scenarios. Pressman and Wildavsky (1973, 122) stress the importance of delay, suggesting that 'Program delay is often difficult to distinguish from program failure'. They offer a three variable model to account for delay, in which direction of preference, intensity (defined as willingness to utilize resources), and resources are the key variables. While the estimates of delay contained

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in this paper are as arbitrary as they confess their own to be, I believe that the addenda I propose to the model represent something of an improvement in the coverage of delay since (1) the same probability model can be applied to variable odds of implementation and to variable amounts of delay, and (2) an analytic distinction between non-implementation and delay is maintained. Further elaboration of the model would be necessary to yield an improved basis for estimating delay, work which has not been undertaken here. Such elaboration might well make use of the resource variables Pressman and Wildavsky discuss. It might also posit an 'internal clearance' factor which conceptualized a delay as a function of the scale of organizational actors and the stature of organizational representatives to negotiating sessions such that, *ceteris paribus*, internal clearances would take longer as the number of internal organizational bases to be touched increased.

Fourth, a provision for bandwagon effects such that the odds of subsequent clearances are conditional upon the achievement of prior clearances introduces an element which must frequently be realistic. When applicable, the bandwagon addendum leads to several non-obvious conclusions, among them the need to think in terms of independent actors rather than independent clearances, the wisdom of investing in repeated attempts for clearances toward the beginning of implementation processes, and the observation that there exists a limit on the number of clearance points which are decisive to success or failure in implementing programs.

Fifth, policy reduction represents an analytic advance over wholistic conceptions of policy because it enables us to account for the kind of partial implementation of policy which actually occurred in Oakland and which is the expected outcome for most implementation processes. Without the policy reduction addendum, probability theory could not have been used to assess the not unheard of strategem of 'throwing resources at problems', the strategic advantage of establishing priorities and ruthlessly focusing resources upon a limited number of programs or program components, or the wisdom of designing programs which consist of components for which independent implementation is meaningful.

Advice to hopeful implementers

The great hope of any mathematical modeller is that use of the recommended model will lead to interesting and non-obvious results. This advisory checklist to hopeful implementers, drawn from the more discursive presentation in the preceding section, represents a partial fulfillment of that hope. While the tactics of persistence, packaging of clearances, engineering a bandwagon effect, designing programs which consist of independent components, and focusing resources on a limited number of objectives are

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familiar and unoriginal, I believe that some of the propositions which follow about the relative efficacy of these strategems are non-obvious. Possibly some of the subsidiary propositions which follow are provocative as well. This advice to hopeful implementers is as follows:

1. Be persistent. Persistence, or repeated attempts to gain a single clearance, is a more effective way to increase the chance of successful implementation than is the packaging of clearances in negotiating sessions or the reduction of policy to independent components.

A. Persistence makes its greatest contribution to implementation success when undertaken early in an implementation scenario.

B. Persistence increases both the probability of eventual success and the amount of delay.

C. Limited persistence (2 or 3 attempts) will be sufficient to gain compliance when initial odds for a clearance are above .5.

D. Extended persistence will be necessary if initial odds of compliance are below .5. In this situation, implementers should consider their resources, the maximum delay which is tolerable, and other policy options.

2. Use multiple implementation scenarios. Multiple scenarios contribute as much to the chance of successful implementation as does persistence, and more than packaging of clearances or program reduction.

A. Multiple implementation scenarios need not lead to delay if resources are available to undertake them simultaneously.

B. Multiple implementation scenarios are preferable to persistence when time is limited.

C. Persistence is preferable to multiple implementation scenarios when resources are scarce.

3. Reduction of programs into components which can be implemented independently contributes more to avoiding implementation failure than does packaging of clearances.

A. If resources are scarce, concentrate on a limited number of program components.

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B. Use resources for persistence and/or multiple implementation scenarios rather than attempting broad coverage of program components.

C. The greater the number of components to which a program has been reduced, the less important the initial odds of clearances for partial program implementation.

4. *The number of clearances which determine a program's fate is finite, calculable, and less than seventy.*

A. Without persistence, multiple implementation scenarios and bandwagons, the number of clearances which make failure more likely than total success if four (if the initial odds for each clearance are .8).

B. If you can be satisfied with a partial implementation success, the number of clearances which makes failure more likely than success is ten (if the initial odds for each clearance are .8).

5. *Aim for additive rather than multiplicative probabilities.* If you are willing and able to think in terms of probability theory, the most succinct advisory is as follows: avoid situations which are isomorphic with the multiplicative model from probability theory; try for isomorphism with the additive model; take advantage of conditional probabilities.

6. *Obtain information about clearance times and the bandwagon effect.* If you ever commission implementation studies, fund those which provide empirical estimates of the actual time spent on obtaining clearances and/or those which provide empirically based estimates of the conditional probabilities associated with the bandwagon effect.

NOTES

1 Pressman and Wildavsky's work has also been considered as an example of a 'garbage can hierarchy' or 'organized anarchy', and linked to a stochastic process model and Markov Chains (Padgett, 1980). Organized anarchy has three defining characteristics: problematic (or unclear) goals, unclear technology and fluid participation (Cohen and March, 1974, 3). I believe the analogy between implementation processes and organized anarchy is somewhat misleading in that the identification of implementation failure requires the specification of clear goals.

2 Weber, of course, distinguished the exercise of authority from the use of other forms of power. His understanding of power is a familiar one – the gaining of compliance in the face of resistance. But power based on authority was only manifested, according to Weber, when, among other things, those complying did so due to a suspension of their own judgement. Power based on the persuasion (intellectual or through the kind of manipulation of incentives known as 'strong arming') of persons exercising independent judgement belongs to a realm of behavior in which authority is absent, would not be part of a Weberian bureaucracy, and more closely resembles

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the bargaining characteristic of politics as conceptualized by a conflict theorist of reductionist bent. Weber's original statement is translated in *The Theory of Social and Economic Organization,* (1968), 152–3, 324–5. Blau and Scott (1962) offer an insightful summary which emphasizes the role of suspension of judgement in distinguishing authority from other forms of power.

3 There are, of course, other themes in the disciplinary literature about implementation. Kaufman (1960) finds compliance where one would have expected implementation difficulties. Sapolsky (1972) reports an implementation success due to effective leadership. Rein and Rabinowitz (1978) consider both the complexity of joint action hypothesis and link implementation difficulties to legislative or formulation weakness. Nakamura and Smallwood (1980) attempt a typology of implementation scenarios in which the extent and foci of conflict varies.

4 This format for presenting formulae is similar to that employed by Blalock (1979) and is intended as an aid to readers without mathematical training. Blalock can also be consulted for a non-technical discussion of probability theory.

5 Persistence can take at least two forms: (1) the simple repetition of a request or (2) the introduction of a new, but equivalent, request. The first possibility is what is referred to in the quotation just cited. The second actually constitutes the use of multiple implementation strategies which are attempted simultaneously. The additive model from probability theory applies to both modes of persistence, as to the figures shown in Tables 2 and 3. Multiple implementation strategies are linked to a 'program reduction' addendum in Table 8. The quotation can also be interpreted as meaning that $P1 < P2 < P3$. This interpretation would, of course, heighten the contribution of persistence to eventual implementation.

6 Further development of the use of conditional probabilities might require a declining increment in order that probabilities not surpass unity or fall below zero. (See formulae presented in conjunction with the persistence addendum and Table 2.) In effect, the modelling of persistence requires use of the addition rule to calculate probabilities at each clearance point and then use of the multiplication rule to obtain the probability of complete implementation. Modelling multiple implementation scenarios requires use of the multiplication rule first and then use of the addition rule.

7 A case for wholistic conceptions of policy can be found in Majone and Wildavsky, (1979).

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The Politics of Blame Avoidance*

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ABSTRACT

Politicians are motivated primarily by the desire to avoid blame for unpopular actions rather than by seeking to claim credit for popular ones. This results from voters' 'negativity bias': their tendency to be more sensitive to real or potential losses than they are to gains. Incentives to avoid blame lead politicians to adopt a distinctive set of political strategies, including agenda limitation, scapegoating, 'passing the buck' and defection ('jumping on the bandwagon') that are different than those they would follow if they were primarily interested in pursuing good policy or maximizing credit-claiming opportunities. These strategies in turn lead to important policy effects, including a surrender of discretion even when it offers important credit-claiming opportunities.

Every time I fill an office, I create a hundred malcontents and one ingrate.

–Louis XIV

One of the most important and least studied trends in modern government is the move toward increased 'automaticity' – i.e., self-limitation of discretion by policymakers. Examples of this process are manifold. Discretion over benefit levels in many income transfer programs has been replaced by automatic adjustments for inflation (indexation). Civil service mechanisms have replaced patronage appointments as the major means of filling bureaucratic posts in most industrialized countries. Formula grants have replaced discretionary grants in transfers from central to local governments. More recently, automatic mechanisms have even been employed in budget-making, most notably in the Gramm-Rudman-Hollings budget cutting initiative in the United States.

The growth of discretion-limiting devices in government calls into serious question much of the accepted thinking about the way public

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policy is made. Policymakers are usually seen as seeking through their activities and votes to 'claim credit' with constituents and clientele groups for actions taken in their interests (Fiorina, 1977).

While credit-claiming is certainly a major component of policymakers' motivations, it is not the only one.[1] Policymakers may also have *non-electoral* motivations such as vote-trading. In countries with a relatively weak system of legislative party discipline, individual legislators may exchange votes on issues of low salience to themselves and their constituents for other legislators' votes on seemingly unrelated issues. Policymakers may also have 'good' policy motivations – i.e., they may act because they think an action is worthwhile even if it has no political payoff. And they may be guided by power considerations within their respective institutions – e.g., their party caucus, legislative chamber or committee, or agency (Fenno, 1973).

A second electoral motivation must also be considered, however. Policymakers are often placed in situations in which the opportunities to claim credit that discretion affords are simply not worth the associated political costs. As Louis XIV discovered in a non-electoral context, even choices that appear to offer substantial opportunities for credit-claiming can also create ill will from constituencies who feel themselves relatively or absolutely worse off as a result of a decision. Politicians must, therefore, be at least as interested in *avoiding blame* for (perceived or real) losses that they either imposed or acquiesced in as they are in 'claiming credit' for benefits they have granted.

Credit claiming, 'good policy' and blame-avoiding motivations all can influence policy decisions. But do they lead to differences in behavior? And which motivation is likely to dominate when they come into conflict? It will be argued here that blame avoidance leads to patterns of behavior very different from those suggested by the other motivations. Furthermore, when push comes to shove, most officeholders seek above all not to maximize the credit they receive but to minimize blame. In formal terms, they are not credit-claiming maximizers but blame minimizers and credit-claiming and 'good policy' satisficers.

This essay sketches out a theory of policy motivations, giving particular attention to blame-avoiding. Specifically, it addresses: (1) how blame avoidance differs from and interacts with the credit-claiming and 'good policy' motivations; (2) the situations in which blame-avoiding is most likely to occur; (3) the forces that have led to an increase in the relative importance of blame avoidance in recent years; (4) specific strategies that flow from blame-avoiding; (5) differences in the way that blame avoidance is manifested in the United States and in parliamentary systems; and (6) the consequences of blame avoidance for policy outputs and outcomes.

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Blame-Avoiding as a Policy Motivation

This study will assume that most policymakers are motivated in large part by their desire to maximize their prospects for reelection (or reappointment) and advancement. It will, therefore, give primary attention to electoral motivations. But how can decisionmakers arrange their calculus to enhance their prospects of staying in office? As a starting point, we would expect decisionmakers to attempt to maximize gains realized by their constituents while minimizing losses – i.e., to take actions for which they can maximize credit and minimize blame.

This is not a simple calculation, however. Constituency costs and benefits do not translate directly into political gains and losses for officeholders. Constituents are much less likely to notice widely diffused costs or benefits than those that are relatively concentrated in a smaller group of the constituency; the former will probably be heavily discounted. And groups of constituents that are poorly organized and have few political resources are again likely to have policy effects relating to them heavily discounted.[2]

Taking these caveats into consideration, it might be argued that a policymaker will, given a range of policy alternatives, choose and strongly support the one that maximizes net constituency benefits (i.e., the surplus of concentrated benefits over concentrated costs) to his or her constituency. But even this formulation is still too simplistic. Pursuit of a constituency benefit maximizing, credit claiming strategy is rational only if constituents respond symmetrically to gains and losses – for example, if a dollar of income gained by one set of constituents as a result of a policymaker's actions wins as much support as a dollar lost to another group costs. But there is substantial evidence that this is not so (Kahneman and Tversky, 1984). Persons who have suffered losses are more likely to notice the loss, to feel aggrieved and to act on that grievance, than gainers are to act on the basis of their improved state.

In short, voters are more sensitive to what has done done *to* them than to what has been done *for* them.[3] Thus the concentrated losses to constituents need not outweigh benefits for a policymaker to have strong blame-avoiding incentives; it is enough that those costs are substantial. When this situation arises, policymakers will probably attempt not to maximize credit claiming net benefits but to minimize blame generating losses.

Much evidence suggests that constituencies are more sensitive to losses than to gains. Using aggregate time-series data for the United States, Bloom and Price (1975, p.1244) found that members of the incumbent President's party are likely to lose seats in Congress during recession, but an economic upturn does not have an equal reciprocal effect. They

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conclude that 'in bad times the economy becomes a salient issue, whereas in good times it diminishes in importance relative to other determinants of voting behavior.'[4] Using individual-level data, Samuel Kernell (1977) found that in midterm Congressional elections, independent voters who disapprove of the President's performance are more likely to vote, and to vote against the President's party, than those who approve of his performance; party identifiers in the President's party who disapprove of the President's performance are more likely to defect to vote against that party than members of the other party who approve of his performance are to defect to support his party.

Disproportionate attention by constituents to questions on which they disagree with policymakers may occur on a variety of other fronts. Gerald Wright (1977) found that Republican supporters of President Nixon on the House Judiciary Committee that considered his impeachment received considerably fewer votes in the 1974 election than would otherwise have been anticipated; Nixon's critics on the Committee did not receive a bonus, however.

The classic case of negativity bias on non-economic issues concerns gun control: opponents of stricter gun control are highly mobilized (primarily by the National Rifle Association), and because many of them view a legislator's opposition to gun control as a vote-determining issue, they are able to exert electoral influence disproportionate to their numbers. Similarly, opponents of abortion or supporters of the proposed Equal Rights amendment to the US constitution might be more likely to see their legislator's position on that issue as a salient, vote-determining issue if it disagrees with their own position than if it is consistent.

Interest groups have also discovered that they can use negativity biases as a tool in fund-raising for specific causes and candidates. By centring their appeal around the danger posed by a specific 'devil-figure' (e.g., Jesse Helms or Jane Fonda) or by raising the spectre of specific losses to the recipient (e.g., of Social Security benefits) they can focus blame while providing an immediate outlet – sending funds – for that blame.

Discounting by politicians of constituency gains (or positive evaluations) relative to losses (or negative evaluations) thus seems quite appropriate. While politicians always have incentives to avoid blame for constituency losses, discounting magnifies and sharpens these effects. Response to blame-avoiding incentives can lead to distinctive patterns of behavior by policymakers on at least three dimensions (Table 1). With respect to choices among policy options that offer differing combinations of social and political benefits, we would expect that policymakers motivated by 'good policy' reasoning would seek to maximize net social welfare, although they might disagree as to the exact meaning of that term. Credit-claiming decisionmakers, on the other hand, would focus on

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TABLE 1: *Attitudinal Manifestations of Policymakers' Motivations*

Dimension:	Good Policy	Credit-Claiming	Blame-Avoiding
Attitude toward costs and benefits:	Maximize net benefits to society	Maximize surplus of concentrated (claimable) constituency benefits over losses	Minimize concentrated losses, even when it means sacrificing greater benefits
Attitude toward discretion:	Indifferent or opposed	Favorable	Suspicious
Attitude toward policy leadership:	Indifferent	Favorable	Suspicious

political impacts, and hence on the balance between concentrated gains and losses for groups relevant to them. Blame avoiders, finally, would also focus on political consequences, but they would tend to discount potential gains relative to losses in their calculus, and thus to minimize blame before being concerned with building political credit.

The three policy motivations also suggest differing behaviors with respect toward exercising policy leadership and policy discretion. A 'good policy' orientation would suggest indifference toward exercising policy leadership, because it is the substantive outcome rather than the political credit or blame that is associated with it that is valued. The same logic is true of maintaining policy discretion – indeed, policymakers may oppose discretion by themselves or others if they believe that it will lead to irresponsible policy choices. Credit-claimers, on the other hand, will seek to exercise policy leadership and maintain discretion because it allows them to make more credible claims for credit from their constituents. Blame-avoiders will be suspicious of exercising both discretion over policy and policy leadership, because these 'opportunities' may generate substantial blame as well as credit.

Blame avoidance can be manifested in several ways. Legislators, for example, may try to avoid having to make politically costly decisions or take clear policy positions at all. Failing that, they may vote in favor of legislation about which they have substantial doubts because it would be difficult to explain a contrary vote to their constituents. Or they may cede discretion to the president or an independent agency for making politically costly decisions.

Legislators do not have a monopoly on blame-avoiding, however. This behavior can be found among politicians of all types. Presidential candidates, for example, tend to be more ambiguous on issues where there is a substantial divergence of opinion, presumably because they are more

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concerned about potential blame from those who might oppose any specific position than they are enticed by potential credit from those who agree with the position (Campbell, 1983; Shepsle, 1972; Page, 1976).

President Reagan's behavior toward Social Security through most of his tenure in office has been a classic example of blame-avoiding. In his first year of office, the administration floated a proposal for drastically cutting Social Security cost-of-living allowances (COLAs) for early retirees and delaying them for all recipients. When the plan was criticized, the President disassociated himself from it – i.e., he sought to avoid blame (Stockman, 1986: 187–192). At the beginning of his second term, Reagan said that he would accept cuts in those COLAs only if they were supported by an overwhelming bipartisan majority in Congress – that is, if others took most of the blame.

Blame avoidance does not always lead to ambiguity and inaction, however. If a president (or any other policymaker) is highly dependent upon a constituency that has come to expect change, he may feel compelled to go along. President Johnson's reasoning for his support of the Civil Rights Act of 1964, for example, had a distinctly blame-avoiding tone:

> I knew that if I didn't get out in front of this issue . . . they [the liberals] would get me. They'd throw my background against me, they'd use it to prove that I was incapable of bringing unity to the land I have loved so much . . . I couldn't let that happen. I had to produce a civil rights bill that was even stronger than the one they'd have gotten if Kennedy had lived. Without this, I'd be dead before I could even begin. (quoted in Whalen and Whalen, 1985: 239)

Political appointees and bureaucrats in government agencies also seek to avoid blame. The Food and Drug Administration, for example, is often argued to have been overly restrictive in letting new drugs onto the market – prohibiting the use of drugs that would create some costs but greater gains – because of the huge blame-generating potential of another thalidomide case.

Blame avoiding has a different dynamic in the US judiciary because federal judges have lifetime tenure (except in extremely rare cases of impeachment). Thus while they might not like to be blamed for unpopular decisions, they can withstand blame better than legislators and elective and appointed officials in the executive branch. It was the desire to free judges, and judicial decisions, from such fears that led to their being given a constitutional guarantee of lifetime tenure in the first place. Although having decisions overturned by a higher court is an embarrassment most judges would prefer to avoid, it does not threaten a federal judge with unemployment. (Many state and municipal judges do not have this protection, however.) One reason that the federal courts

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have been able to play an activist policymaking role in the United States over the past thirty years is this greater ability to withstand blame. The judiciary has stood firm in such areas as school prayer and abortion where legislators, subject to extreme blame-avoiding pressures, have attempted to reverse them.

Blame-avoiding motives do not always pose clear conflicts with the other motivations, however. Blame avoidance can also shape the way policymakers attempt to achieve their other objectives. For example, in the early 1970s, Republican lawmakers confronted Democratic initiatives in Congress to raise the real as well as nominal benefit levels for Social Security through ad hoc increases. These fiscal conservatives felt that the benefit changes were not good policy, but they found a vote against them very difficult to explain to their constituents. In an era when reliance on ad hoc changes was perceived as leading to higher real benefits, indexation seemed to offer a way to make a benefit freeze politically palatable – i.e., it reconciled their 'good policy' objectives with blame-avoiding ones.

Sources of Blame-Avoiding Behavior

The claim here is not that all politicians and bureaucrats – or even most of them – are pure blame avoiders all of the time. Politicians in equivalent situations may vary in their aversion to risk, and hence in their willingness to be perceived as imposing or acquiescing in losses rather than minimizing or disguising them. Indeed, politicians may, when placed in difficult blame-avoiding situations, simply refuse to pursue strategies consistent with that situation: John Kennedy's *Profiles in Courage* is a chronicle of individuals who pursued their own views of good policy when placed in blame-avoiding situations. But for every Edmund G. Ross and Thomas Hart Benton in office who eschews blame-avoiding, there are probably many more J. W. Fulbrights who vote against civil rights legislation and Frank Churches who vote against gun control – if for no other reason than that the latter are likely to stay in office longer.

Socialist parties in many countries face a similar dilemma: should they sacrifice their ideological purity (e.g., by watering down or dropping proposals for nationalization) in order to build political bridges with the middle class? An approach which maximizes political credit with party activists is likely to lead to permanent opposition status or (if the party has won office already) to a loss of power.

The justification given by blame-avoiders is simple: they cannot pursue their other policy objectives if they are not re-elected, and they will not be re-elected if they do not suppress their own views of 'good policy' when these views clash with the strongly held opinions of their constituents. Indeed, it might be said that over the long term, *blame avoiding behavior in*

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situations that mandate such behavior is a precondition for pursuing other policy motivations in situations that do not compel that behavior. Those who fail to avoid blame are likely to find themselves unemployed. Even if voters' judgements are only partially based on a desire to punish behavior or views of which they disapprove, politicians still have strong incentives to minimize potential blame, because (1) they cannot be certain which issues might be picked up by future opponents and used against them, and (2) only some, not all, voters need to pursue retribution as a voting objective for a politician's office to be in danger (Fenno, 1978: 141–143).

The number of parties or candidates competing for votes (which itself reflects the entry barriers posed by electoral laws) may influence whether a party stresses credit-claiming or blame avoiding in its electoral appeals. In a two-party system like the United States, the best strategy is probably to take ambiguous stands and duck divisive issues (i.e., to minimize blame) to avoid offending marginal voters. In a multi-party system, on the other hand, some parties may be better off by taking pointed, controversial positions (credit-claiming) in order to build a distinctive political base and avoid becoming lost in a crowded field.

Whether credit-claiming, blame avoiding or non-electoral motivations dominate policymakers' decision-making in a particular policy arena will depend in large part on two factors: (1) how constituent costs and benefits are distributed;[5] and (2) how constituency costs and benefits are translated into political gains and losses.

BLAME-GENERATING SITUATIONS: whereas the absence of concentrated constituency losses may make blame-avoiding motivations irrelevant, at least four situations may lead to blame-avoiding behavior (Table 2). The first is when there is a zero-sum conflict among the policymakers' constituents. Table 2 outlines this situation in its simplest form: a choice between a single alternative policy and the status quo. When concentrated benefits of the alternative policy are high, and costs are low or relatively diffuse, the policymaker can claim credit with constituents for making that choice, as shown in Cell 3.[6] The distribution of 'pork barrel projects' such as dams and harbor projects, for example, is virtually pure political 'profit', for projects are quite visible and costs are broadly spread. Political analyses that focus on credit claiming have generally examined these 'loss-free' activities, and some analysts have even claimed that policymakers skew their own, and government's activities so as to maximize credit-claiming opportunities (Fiorina, 1977: 46).

Politicians can also claim credit when benefits of the alternative are low and costs are high: for example, if a federal facility in a legislator's district is threatened with closure (Cell 2). In this situation, the decisionmaker receives credit for opposing its adoption. (Even here a credit-claiming

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TABLE 2: *Cost-Benefit Distributions and Policymakers' Motivations*

		Perceived net benefits to constituency of policy choice: High	Low
Perceived net costs to constituency of policy choice:	High	(1) Blame Avoiding	(2) Credit-Claiming
	Low	(3) Credit Claiming	(4) Non-electoral motivations (e.g., good policy or vote-trading)

approach is not without risks, however. If leading the opposition to a measure has little prospect of success, and the policymaker feels that he or she is likely to be blamed for failure in spite of having tried, it might be more fruitful to portray him or herself as powerless to influence the decision – i.e., to 'pass the buck' on responsibility to others.)

When both costs and benefits are low, the legislator will be relatively unconstrained, and he or she can act according to non-electoral (e.g., 'good policy' or vote-trading) motivations (Cell 4).

Clearly a policymaker's most difficult choice is in Cell 1, where bringing benefits for one part of his or her constituency requires imposing costs on another segment. In this situation the decisionmaker has two options. He or she can attempt to calculate the strength of the impacts and the power of the groups involved, and then back the side that promises the higher political returns, claiming credit for having done so. But this credit-claiming response risks offending the losers, who are more likely to remember that loss and punish him or her for it. So long as the losses (and thus potential blame) are not drastically outweighed by other groups' gains, we would expect policymakers to focus on gaining credit only after attempting to minimize losses – and therefore blame.

A second situation leading to blame avoidance arises when all possible alternatives have strong negative consequences for at least some of the policymakers' constituents. This is a negative-sum game. Here there is no credit to be obtained. Policymakers can only hope to limit their exposure to blame. This form of blame avoidance is particularly likely to arise when government is allocating budgetary cutbacks.

A third blame-generating situation occurs when constituency opinion is overwhelmingly on a single side of an issue. When consensus is so

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pervasive, there is little credit to be derived from agreement with it – conformity is simply expected. But if a candidate can show that his or her opponent has violated the consensual norm – e.g., is or was a Communist, a drug user or a spouse or child abuser – it can be very damaging indeed. Other forms of personal scandal, such as paternity of an illegitimate child or receipt of bribes, may also lead to an earlier-than-planned exit from the political scene. These can be termed 'consensus-violating' situations. A legislator's attendance at roll call votes is a classic example of this type of blame-generating situation: it provides virtually no credit-claiming opportunities (because voters assume that representatives should be present for all votes), but legislators with poor attendance records have had that fact used against them very effectively in the United States.

A fourth situation in which blame-avoiding behavior is likely to occur is when the personal or policy interests of the policymaker and clientele are opposed. Congressional pay raises are perhaps the classic instance of such a conflict. There could hardly be a clearer opportunity for 'capture' of a decision-making process by an organized group. But there is little political credit to be gained for legislators who favor pay increases and much blame. Indeed, without the concept of blame avoidance it would be difficult to understand why legislators do not vote themselves huge salaries – it is certainly in their economic interest to do so. Legislators are very concerned about incurring political blame, however. It is for this reason that legislators sought to keep the pay raise issue off their agenda by providing for an automatic process of increases. When this proved impossible to implement, legislators were once again forced to vote down pay raises.

ATTRIBUTING BLAME: The argument for a negativity bias in voting behavior assumes that at least some voters base their voting decisions largely on retrospective considerations (i.e., on officeholders' past records) rather than on prospective considerations (expectations of their future performance) or on other factors such as candidate personality or party identification (Fiorina, 1981; Key, 1966). To the extent that voters make choices on grounds other than retrospective ones, politicians have more autonomy – and less need to blame-avoid – in their own choices.

Policymakers may escape blame and obtain autonomy even where there are real or potential constituency losses. Richard Fenno has shown that legislators in the US work to develop enough trust on the part of their constituents that they will have 'leeway' to vote their conscience on some issues (Fenno, 1978: chapter 5). Legislators from relatively safe districts – whether as a result of their own leeway-building efforts, absence of party competition, or some other factor – presumably do not need to be as concerned with avoiding blame as those with only a marginal hold on office. Any leeway that is achieved is rarely complete, however. There is

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evidence that US senators seeking re-election moderate their voting decisions as an election approaches, presumably because they believe that their constituents are more likely to remember and punish recent 'deviant' votes than older ones. The pattern is just the opposite among legislators not seeking re-election: in this group, Republicans tend to become more conservative and Democrats more liberal between the fifth and sixth years of their terms (Thomas, 1985).

Voters may also err in attributing blame. On the one hand, they may fail to link policymakers to choices they have in fact made or outcomes to which they have contributed. On the other hand, they may attribute a linkage where the policymaker's influence was really weak or non-existent. Perhaps the most durable case of over-attribution was the American electorate's blaming the Hoover administration and the Republican party for the onset of the Great Depression – an image which helped the Democrats for decades.

GENERATING AND AVOIDING BLAME: Policymakers' motivations are not determined entirely by the distribution of costs and benefits among their constituents. They are also determined by the way choices are structured (Riker, 1986). If, for example, alternatives which place policymakers' and constituents' interests in direct conflict can be kept off the agenda, policymakers may be able to reduce blame-avoiding behavior.

On the other hand, the importance of blame-avoiding motivations among policymakers can provide an important boost to those with opposing views. The motives of those opponents may be based on their own notions of good policy or desire to claim credit with their own political constituencies rather than upon blame avoidance. Nor is it necessary that a majority of policymakers (legislators, for example) have strong blame-avoiding motivations for there to be a substantial impact on public policy: it is enough that blame-avoiders hold the balance of power in decision-making. If sponsors of 'hard to vote against' legislation such as Congressional pay freezes and Social Security benefit increases can force the issue onto the agenda and shape it in such a way that it activates blame-generating pressures, they can use others' fears of electoral retribution to force blame-avoiders to support their own proposals.

Thus the shaping of alternatives and agendas is an important determinant of which motivations dominate in specific choice situations. And by shaping motivations, political combatants can also affect policy outcomes. In the battle over the 1981 budget reconciliation bill in the House of Representatives, for example, both sides sought to shape the vote in ways that would limit blame for a vote cast on their side, while maximizing the blame-generating potential of a vote for the opposition. The Democrats sought (and the Rules Committee approved) a rule that

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would have forced separate votes on five sections of the bill. The result was, as David Stockman put it, that 'Republicans – and Boll Weevils – were going to be forced to vote against food stamps and Medicaid and Social Security, out loud and one at a time' (Stockman, 1986: 218). The administration and House Republicans, on the other hand, sought a single up-or-down vote on the entire package. This proposal would disguise votes to cut individual programs. It thus maximized the prospects of winning blame-motivated support from wavering Democrats who, in Stockman's words, 'weren't even remotely genuine fiscal conservatives . . . [but rather] simply muddle-minded pols who had been scared by the President's popularity in their home districts' (Stockman, 1986: 207). A closed rule was adopted in a House floor vote, ensuring passage of the administration-backed package.

Forces Increasing Blame-Avoiding Behavior

Blame-avoiding is by no means a new phenomenon in policymaking. But a number of changes in American society – notably in the economy and fiscal climate, in the way political campaigns are run, and in the way Congress operates – have increased incentives to engage in blame-avoiding behavior.

Fiscal stress has given politics an increasingly zero-sum cast. Programs are forced to compete in the political market-place for funds. Budget deficits have also increased the involvement of budget guardians (notably the Office of Management and Budget and congressional Budget committees) in public policymaking. These developments have undercut the ability of clientele and policy specialists to keep decision-making within a narrow (and favorable) policy subsystem, and have forced politicians to engage in more loss-allocating activities.

Incentives for blame avoidance have also increased in recent years by the decline of party as a determinant of electoral behavior. Incumbent legislators have responded to party decline '[b]y developing a reputation with a minimal amount of partisan or ideological content, . . . induc[ing] constituents to evaluate them separately from the state of the nation and the performance of parties and administrations' (Ferejohn and Fiorina, 1985: 94–95). In this situation, voters are likely to continue returning the incumbent *unless they are given a reason not to*. Legislators know it, and their potential opponents know it. Thus legislators must be concerned primarily with avoiding giving their opponents a popular election issue. But challengers have been given new tools as well. In particular, the ability of television advertising to present quick, simple negative images

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in voters' minds can undermine confidence in the incumbent, reinforcing legislators' reluctance to vote against positions likely to appeal to poorly informed constituencies.

Political and policy changes have also stimulated blame-generating behavior within Congress. Legislators are no longer dependent on their party's apparatus to win the party nomination, nor on party funds or party image to win the general election. As a result of the decline of norms of apprenticeship and the growth of formula funding for federal grant programs, junior members are no longer dependent on the largesse of more senior members to win benefits for their districts. In this environment, members are less likely to forgo credit-claiming opportunities that require them to force blame-generating choices on their colleagues. If their colleagues do not like to take an open stand on such classic blame-generating issues as congressional pay raises, federal funding of abortions and a balanced budget amendment to the constitution, that is just too bad.

Interest groups are also getting more sophisticated at generating blame. The Americans for Tax Reform coalition, for example, has attempted to persuade all House and Senate candidates to pledge that they will not raise taxes above levels in the 1986 tax bill. The idea is to raise the salience of the issue and to force legislators to make binding commitments which they otherwise would not make – and will not be able to break without incurring charges of bad faith. Other groups have published 'Dirty Dozen' lists (i.e., lists of the dozen legislators with the worst voting records on a particular issue, such as environmental protection) as a means of focusing blame on legislators whom they hope to defeat or whose behavior they hope to modify.

At the same time, a series of Congressional reforms have undercut the ability of legislative specialists to control the legislative agenda. Rules changes enacted in 1970 made it easier for House members to gain floor consideration of amendments. Thus issues like indexation, which might not have reached the floor in prior years because they did not fit the 'credit-claiming' interests of the specialists, are reaching the floor. And once non-specialist legislators are forced to take a position on indexation, they find it very difficult to vote no, even if they might prefer to do so. The institution of recorded teller votes in the House of Representatives in 1970 (followed by electronic voting in 1973) dramatically increased the number of issues on which Representatives were forced to take recorded positions, further intensifying the pressures for 'blame avoiding' behavior (Oleszek, 1984: 140–142). And because legislators often know little about the precise amendment they are voting on, and cannot predict which issues may be raised and cast in a blame-generating light by a challenger in a future election, they search for politically safe solutions.

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Policymakers have not been indifferent to these increasing blame-avoiding forces, however. In the past few Congresses, the House of Representatives has made increasing use of restrictive rules that limit the introduction of 'hard to vote against' amendments.

The House has also responded to another consequence of increased roll-call voting – namely, increased pressures to be present for many votes – in a blame-avoiding fashion. The House leadership responded to the universal collective blame-avoiding interest of its peers by scheduling most roll-call votes on Tuesdays through Thursdays, lessening pressures to be in Washington and freeing members' schedules both for committee work and time in their home districts.

Blame-Avoiding Strategies

Policymakers can respond to potential blame-generating pressures in several ways. They can, first of all, attempt to prevent a blame-generating situation from arising in the first place. If that fails, they can attempt to deflect blame to others or at least diffuse it broadly. At least eight specific strategies can be identified as flowing from these blame-avoiding motives.[7] (Table 3)

1. Limit the Agenda: The best way for policymakers to keep a blame-generating issue from hurting them politically is to keep it off the agenda in the first place. The successful Republican effort to prevent separate votes on a series of specific program cuts in the 1981 budget reconciliation bill is a good example.

If legislators engage in blame-avoiding behavior only because they have to, why don't they simply band together to make it unnecessary by keeping all blame-generating choices off the agenda? In many cases they do. American political institutions have been shaped to a very substantial degree by policymakers' attempts to limit their need to blame-avoid. The long-time closed rule in the House of Representatives for Ways and Means Committee legislation restrained the enthusiasm of non-Committee members for proposing budget-busting tax breaks for specific constituencies. Equally important from the Committee's perspective, this agenda limitation allowed Ways and Means members to perform their role of budget guardian for the institution without having to oppose those amendments on the floor – i.e., it prevented a blame-avoiding situation from arising.

Legislators cannot always cooperate to make blame-avoiding behavior unnecessary, however. There are several reasons why. The most important is that some issues pit the blame-avoiding interests of one group of legislators against the credit-claiming and policy interests of others. If

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TABLE 3: *Eight Blame-Avoiding Strategies*

Strategy:	Approach to Avoiding Blame:	Blame-generating situations where most likely to occur:
1. Agenda limitation	Prevent blame-generating by keeping potentially costly choices from being considered	Policymaker-constituency conflict
2. Redefine the Issue	Prevent blame-generating by developing new policy options which diffuse or obfuscate losses	Any
3. Throw Good Money After Bad	Prevent or delay blame generating by providing resources to prevent constituencies from suffering losses	Zero-sum or negative-sum game
4. Pass the Buck	Deflect blame by forcing others to make politically costly choices	Zero- or negative-sum game
5. Find a Scapegoat	Deflect blame by blaming others	Zero- or negative-sum game
6. Jump on the Bandwagon	Deflect blame by supporting politically popular alternative	Policymaker-constituency conflict
7. Circle the Wagons	Diffuse blame by spreading it among as many policymakers as possible	Negative-sum game
8. 'Stop Me Before I Kill Again'	Prevent blame-generation by keeping credit-claiming opportunities that conflict with policy preferences from being considered	Policymaker-constituency conflict

some legislators would prefer not to vote on Congressional pay or on granting a Social Security COLA increase, others see this as an opportunity to lead the fight for those issues. The latter group will seek to force these issues onto the agenda, and the institutional changes that have occurred in Congress since 1970 have reinforced their ability to do so. Thus credit-claiming and blame-avoiding behavior may occur together, but in oppos-

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ing groups: credit-claiming activity forces proposals onto the agenda, and blame-avoiding reactions lead to their adoption.

Even if blame-generating decisions cannot be kept off the agenda completely, policymakers can often at least influence when they must confront them. Thus controversial issues may, for example, be delegated to study commissions with instructions to report just after the election. The issue may thus be removed from the agenda until that time.

Once an issue has made it on to the agenda, blame avoidance suggests several alternative strategies:

2. Redefine the Issue: If policymakers cannot keep a blame-generating issue off the agenda, they may be able to reshape it in such a way as to prevent blame. If an issue divides two industries for example, policies may be devised so that each industry obtains satisfactory outcomes, while costs are spread more broadly.

Blame avoidance is oftentimes not an all or nothing matter, moreover. In Congressional roll calls, legislators are of course forced to make simple yes or no decisions. But even in this arena, legislators often provide themselves with a series of votes to soften (or obfuscate) their position on controversial issues.

3. Throw Good Money After Bad: Sometimes policymakers know that they will be forced to acquiesce in blame-generating losses eventually. This is most likely to occur in negative-sum games (when all possible outcomes involve losses) or when policies have clearly failed. In these cases, decisionmakers cannot keep the issue off the agenda and they may not be able to diffuse the losses enough that their political impact is small. But they may be able to delay those outcomes by committing extra resources to shore up the status quo. In Indochina, for example, US policymakers were guided in large part by the rule, 'Do not lose the rest of Vietnam to Communist control before the next election' (Ellsberg, 1971: 252). Despite pessimism that the war could be won, policymakers did not wish to be branded as having 'lost' a country. On a very different political issue, disposal of wastes from nuclear power plants, a similar pattern can be seen. Wastes continue to be stored at power plant sites because of prolonged wrangling over a permanent disposal site. A first site for a repository is unlikely to be named until 1990 or open before 1998 – 16 years after passage of the act that set up a selection process.

4. Pass the Buck: If a blame-generating decision has to be made, policymakers are likely to try to delegate that decision to someone else (Fiorina, 1982). Congress repeatedly passes protectionist trade legislation, relying on the President to veto that legislation and incur the wrath of affected industries. Decisions on siting of nuclear waste repository facilities are another eminently unpleasant activity that Congress has dumped in the President's lap. Independent regulatory commissions are

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delegated responsibility for many of the most sensitive economic conflicts that pit one firm or industry's interests directly against others (e.g., mergers, rate-making).

Automatic government is a more recent, and increasingly important, manifestation of policymakers' desire to pass the buck to avoid blame. The Gramm-Rudman budget-cutting mechanism is a perfect illustration. Congress sets in motion a process which months or years later causes cuts to be made automatically, with no one directly to blame. Even the officials who would be responsible for sequestering funds are simply following a mandated formula, so they cannot be blamed.

Understanding why politicians would give up discretion over unpopular, cost-generating decisions is relatively easy. But why have they also given up authority over decisions in sectors where there are few or no concentrated losses – for example, over benefit levels in income transfer programs and potential pork barrel decisions in such areas as federal grants?

Understanding that politicians are blame-avoiding and risk averse can help to explain this apparent anomaly. This is clearest for legislators. Congressional incumbents have a number of tools at their disposal – constituency casework, mail to their constituents, etc. – that provide credit claiming opportunities. Thus the primary concern for the bulk of incumbents must be not to give an attractive issue to a challenger. Given this situation, their incentive is to neutralize – i.e., make unlikely to generate blame even if it sacrifices credit-claiming opportunities as well – any issue which has a significant prospect for generating blame. In choosing whether to maintain discretion over any program or give it up, legislators must take into account the prospect that they might in fact lose benefits for their constituents in future rounds, and that a future election opponent could use this as an election issue against him or her. (Indeed, it is not even necessary that actual losses occur – only that the opponent claim that they could do better.) Moreover, resources spent influencing these allocation decisions must be taken from a limited supply, and those resources can be better spent in decisions with less blame-generating potential. Forgoing discretion is, in short, likely to be a politically safer response except where the possibility that one's constituency will suffer real losses is remote.[8]

5. Find a Scapegoat: If a politician can't pass the buck for an unpopular decision, he or she may be able to pass the blame for it instead. The usual tactic is to claim that your actions were made necessary by the actions of your predecessors: President Reagan, for example, has claimed that austerity measures were required because of profligate spending by past Democratic administrations and Congresses. Prime Minister Thatcher has made similar claims in Great Britain.

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Scapegoating can also be useful when past scandals or policy gaffes are discovered. President Reagan has been able to use his decentralized management style to deflect blame to subordinates on many occasions, giving rise to the term 'Teflon presidency' (nothing sticks to the President). The limits to this strategy appear to have been surpassed only in the Iran/Contra arms imbroglio, where there is a broad popular perception that the President either knew more than he was saying or should have exercised more control over his subordinates.

6. *Jump on the Bandwagon:* On issues which pit a policymaker's views versus those of his or her constituents, he or she may be able to switch sides unobtrusively – to jump on the bandwagon – when it becomes evident that other strategies (notably agenda limitation and redefining the issue) have failed to keep a blame-generating situation from arising. If the policymaker's original position has not been made publicly, he or she may even be able to claim credit for holding the popular position all along. This desire to turn blame into credit is the source of the curious Congressional phenomenon of seemingly unimportant procedural votes that are in fact more important than final votes on passage. The unobtrusive procedural vote, which may be closely fought, reveals the balance of forces between the two contending sides. Once it is clear which side is likely to win, legislators may feel that their vote in favor of an unpopular side no longer serves any useful purpose. They can thus switch their vote to support the more popular side on final passage.

A clear example of failed agenda limitation followed by a bandwagon effect can be seen in the 1986 House debate on an omnibus drug bill. With an election less than eight weeks away, members were extremely reluctant to appear 'soft on drugs'. Liberal Democrats criticized their own leadership for failing to preclude floor consideration of Republican amendments that would require military participation in anti-drug efforts, limit the application of the 'exclusionary rule' on illegally seized evidence, and permit imposition of the death penalty in some drug cases (Rovner, 1986). Forced to take a stand on these issues (in a House atmosphere that two of them described as 'a mob mentality' and 'panic and hysteria'), many liberal Democrats defected to support them (Feuerbringer, 1986). On final passage they defected overwhelmingly, despite inclusion of all the Republican amendments. The bill passed by a vote of 392–16. The possibility of a Senate filibuster was then dismissed by House Majority Leader Jim Wright, who argued, 'Anyone responsible for preventing this legislation from being enacted will have an angry American public to answer to' (Rovner, 1986: 2126).

7. *Circle the Wagons:* This strategy is based on the same principle – safety in numbers – as the 'jump on the bandwagon' approach. It is most likely to be found in negative-sum situations, where there are only losses to be

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allocated and no way of evading the unpleasant choices. If the 'pass the buck' and 'throw good money after bad' options are no longer viable, decisionmakers may find themselves in a situation where they have a common interest in diffusing the inevitable blame by arriving at a consensus solution. Thus no one has to stick their neck out: everyone provides political cover for everyone else, making it difficult for a future political opponent to raise the issue. When it works best, this approach may even yield political dividends – for taking the hard, gutsy stand (which everyone else is taking as well).

'Circling the wagons' is invariably a risky strategy, however. It will work only if near-unanimity can be maintained. If some participants in the process see an opportunity to deflect the blame to others and claim credit for resisting the loss-producing solution, they will be sorely tempted to defect from the consensus. Thus all participants will be afraid to publicly take the lead in proposing solutions; unless agreements can be negotiated quietly, with commitments of support made in advance, they are unlikely to succeed.

8. 'Stop Me Before I Kill Again': Policymakers are not, as has been noted, single-minded seekers of re-election – they are also likely to have preferences for 'good policy'. Sometimes politicians are faced with a choice between a politically popular position – a credit-claiming opportunity – and what they believe to be a responsible policy position. If they vote against that choice, on the other hand, they may incur a lot of blame. If policymakers are simply credit-claimers, they will sacrifice their policy preferences, 'jump on the bandwagon', and support the politically popular position. Thus the analogy to the murderer who asks that he be stopped before he kills again: the policymakers know that what they are doing is wrong, but they can't help themselves. This was the situation that fiscally conservative Republicans in Congress found themselves in as they resisted politically popular Social Security benefit increases in the early 1970s. But as they discovered, jumping on the bandwagon is not the only response: if they limited their discretion over the choice, they could avoid blame and obtain their policy preferences at the same time (Derthick, 1979: 349–350). A similar logic is used by many proponents of constitutional limits on government expenditures: i.e., it is the only way to force legislators to collectively exercise spending restraint, since none of them wishes to vote against individual spending programs (Wildavsky, 1980).

The strategy policymakers choose depends in large part on the nature of the blame-generating situation – e.g., whether it pits constituency versus constituency or policymaker versus constituency (Table 3). A 'jump on the bandwagon' strategy may be an effective response to policymaker-constituency conflict. It might not be a viable option in a zero-sum conflict between constituents, however, for no single option may

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placate all sides. Passing the buck, scapegoating, redefining the issue or throwing good money after bad are all more likely to be more successful in this type of situation. Choice among these options will depend upon the costs and likelihood of success of each option (e.g., if there is a credible scapegoat or entity to which the buck can be passed).

Blame Avoiding in Comparative Perspective

The discussion of blame avoidance has to this point focused on examples drawn from the United States. But the political importance of generating and avoiding blame is by no means a uniquely American phenomenon. It has its roots in a specific set of structural conditions, viz. (1) loss-allocating activity by government, and (2) the ability of citizens and/or politicians to hold government officials accountable, be it through elections, votes of confidence in Parliament, demonstrations, or coups d'etat.

The more governments attempt to do, the more likely they are to be held liable for poor performance, or for policy changes that impose losses, in those sectors. Governments that regulate or subsidize the retail price of basic foodstuffs, for example, are likely to face strong pressures not to raise prices. When they finally do so as a result of rising budget deficits or pressure from the International Monetary Fund, they may face huge protests. Governments that have accepted a responsibility for maintaining full employment, Sweden, for example, make even conservative parties reluctant to allow unemployment to rise when they come to power (Jonung, 1985; Weaver, 1987), whereas in the United States the federal government is partially shielded from attack by public beliefs that it is unemployed individuals rather than government who are to blame for their unemployment (Lau and Sears, 1981; but see also Weatherford 1978; Weatherford, 1983).

The type of resources available to potential 'blame generators' and to those who seek to avoid blame will affect both how much blame-avoiding those in power have to do and the strategies with which they choose to do it. If governmental power is highly concentrated, as in Eastern Europe, a pass the buck strategy of avoiding blame may work for individual functionaries and ministries, but it will not work for government (and party) as a whole. Authoritarian governments can suppress blame, but they cannot avoid it. Authoritarian governments occasionally fall, or at least change their leadership, in response to political pressure. Gomulka was deposed in Poland to placate public protest over food price increases; Krushchev fell in the Soviet Union in part due to elite dissatisfaction with his 'hare-brained schemes' in agriculture. In short, where centralization of power makes buck-passing less credible as a strategy to avoid blame, scapegoating is likely to be an important blame-avoiding strategy.

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Parliamentary institutions also have distinctive impacts on how blame is generated and avoided. Indeed Great Britain, without a written constitution to constrain government, relies ultimately on politicians' fears of attracting blame as a constraint. A full treatment of this topic is not possible here, but a few points can be made. Blame avoiding in the United States is highly decentralized and individualistic, reflecting the great leeway given to individual political entrepreneurs in a system of governmental checks and balances, weak and incoherent parties, and decentralized campaign financing. Both blame-generating and blame-avoiding in parliamentary systems tend to be much more party- and government-centered, reflecting strong party images and party discipline in the legislature. These strong party images make blame-generating much easier. Rose (1984: 49) indicates that party leaders in British election campaigns generally spend more time attacking the other party(ies) than in defending their own party's position and record.

Party discipline seriously constrains the blame-avoiding options for legislators. This is especially true in party list systems, where control over placement on the list gives party leaders a strong mechanism to punish disloyal behavior. Even in a single-member constituency system, the fact that the careers of Members of Parliament are highly dependent on advancing within their party caucus means they cannot do as their American counterparts might: disavow, vote against, and even lead the legislative fight against policies proposed by their party's leaders in the executive.[9] Voters' recognition that their legislator must adhere to party discipline partially shields an MP from *personal* blame for his or her votes, but it cannot absolve completely. MPs can also attempt to insulate themselves from their party's unpopular policies by that quintessential credit-claiming activity, constituency work (Cain, 1983). But this is a substitute for, rather than a form of, individual blame-avoiding.

So long as there is a majority government, opposition parties in parliamentary systems can do little other than generate blame, for they cannot hope to have an effective voice in formulating policy. In countries with Question Time or its equivalent, this blame-generating process has become highly institutionalized. The opposition seeks to embarrass the government, and the government seeks to dodge the questions, obfuscate or counterattack.

Although the opposition can embarrass the government and attempt to force it to consider issues of the opposition's choosing, the government can virtually monopolize the actual legislative agenda. It can refuse to bring up legislation when it does not wish to, and attempt to bury controversial issues by consigning them to commissions or parliamentary committees. Government can also largely control how those issues will be defined in the legislative process. The ability to control agendas also imposes

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burdens on parties in parliamentary systems. Because governing parties are supposed to govern, evidence of disunity, such as an open backbench rebellion, may have adverse electoral consequences (Jackson, 1968: 300–301). Thus potential rebels may be able to use the blame-avoiding instincts of their Whips to win a favorable behind-the-scenes accommodation of their views.

Parliamentary government also makes it particularly difficult for these governments to dodge blame for losses they have imposed or acquiesced in, because it concentrates authority and accountability in the government-of-the-day and provides regular opportunities to hold government accountable (Weaver, 1985). There is no one to whom the buck can be passed and, in most cases, it is transparently obvious that government could have intervened to prevent the loss, especially for micro-level changes such as a coal mine closure in Wales or a rail line abandonment in Western Canada. Governments in parliamentary systems are thus likely to face very strong pressures to 'throw good money after bad' to prop up failed policies. Officials in the executive cannot use the legislature as a scapegoat (and vice versa) in the United States. In theory, ministers who are responsible for failed policies can resign as scapegoats, but this usually occurs only in the case of scandal rather than failed policies. The principle of collective cabinet responsibiliity assures that the government as a whole will share in any blame for failed policies. Governments may, however, have somewhat more freedom in distancing themselves from blame for macro-economic conditions than for micro-level ones: the Thatcher government, for example, was able to win re-election in 1983 in part because 'whilst high unemployment has consistently been seen as the most important issue facing the country, expectations as to its solution are low, and the government has been decreasingly singled out as the sole cause of the problem' (Richardson and Moon, 1984: 30).

There are also differences among governments in parliamentary systems, especially between majority governments and minority or coalition governments. There is some evidence that weak coalition governments escape blame for poor economic performance when stronger, single-party, majority governments could not (Paldam and Schneider, 1980; Lybeck, 1985). On the other hand, these governments may be subject to collapse at any time because one or more parties does not wish to be associated with an unpopular policy choice. Hence, policy decisions are especially likely to have a blame-avoiding cast in coalitions. Moreover, because coalition partners are likely to be competing for the same voters in the next election, they may try to generate blame against their partners while trying to build a blame-minimizing record themselves. Indeed, parties' reasons for staying in government may well be

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based on blame avoidance: a fear that they will be punished by voters for causing the collapse of the government.

Blame Avoidance and Policy Outputs

The analysis outlined above suggests that blame avoidance may lead policy alternatives to be chosen that might otherwise fail. In this sense alone, it has an important impact on policy outputs, if only the passive one of influencing choices made from among a set of alternatives determined by 'good policy' advocates and credit-claimers. But blame-avoiding also affects the alternatives considered.

The limitation of policymakers' discretion through indexation, formula grants, merit hiring and promotion and other more or less automatic mechanisms is the foremost example. Blame avoidance can help to produce discretion-reducing decisions in three ways. First, policymakers may themselves seek the reduction of discretion because they believe that it offers few credit-claiming opportunities and high prospects for blame. Louis XIV's rueful comment about malcontents and ingrates reflects this concern. Gramm-Rudman is a more recent manifestation of this phenomenon: discretion to cut popular spending programs is not the kind of discretion that politically astute decisionmakers wish to exercise. Reduction of discretion is, in short, a way of 'passing the buck'.

Second, policymakers may wish to maintain discretion to take advantage of credit-claiming opportunities, but be forced to reject it when their opponents mobilize opposition to continued discretion. The elimination of patronage when it became an issue of 'good government' is an example. Here reduction of discretion follows from a 'jump on the bandwagon' mentality.

Finally, policymakers may come to favor a reduction of discretion because they believe that exercising discretion forces them to make unacceptable choices between obtaining substantial credit but very bad policy, on the one hand, or incurring substantial political blame, on the other. The support of conservative Republicans for Social Security indexation as a way to avoid having to vote either for or against real benefit increases was noted earlier as an example of this 'stop me before I kill again' motive for reducing discretion.

Several other consequences of blame avoidance are also important. Blame avoidance can, for example, help to explain why policymakers often urge competing interest groups to work out differences among themselves and arrive at a consensus position which is then endorsed by those officials. Doing so limits the ability of decision-makers to claim credit for reaching an agreement. More importantly, it allows them to

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avoid taking positions and making decisions that will offend one or more of the groups.

Understanding blame avoidance also can help us understand the limits on interest group capture of governmental institutions. Even if a specialist clientele is normally the only 'attentive public' for an agency or Congressional committee, those bodies know that they cannot go too far in pursuing that clientele's interest without attracting unwanted outside attention. Regulatory agencies can have their decisions overturned by the courts, Congressional committees by their full bodies. There is also the potential embarrassment of being shown to be too solicitous of a clientele.

This is not to say that catering to specialized interests does not occur. It does. Indeed, it is inevitable – even endemic – in a system such as the US one, which allows agencies and committees substantial autonomy within a system of multiple, intermittently exercised checks. But the 'capture' process is one that has natural limits based on blame avoiding – namely, the agency or committee's fear of mobilizing latent constituencies or governmental checks – i.e., of attracting blame.[10]

Blame avoidance also helps to explain why policies are so difficult to change, even if they fail. If policymakers and their constituents perceived costs and benefits symmetrically, they would be willing to change policies quite freely, at least as long as the new policies promised at least as high a surplus of concentrated benefits over costs as the status quo. But substantial vested interests often develop around programs. Because costs and benefits are perceived asymmetrically, policymakers fear that new policies will not win them as much support as dismantling the old ones will lose. They are thus afraid to dismantle policies, and when they do, they may 'grandfather' in current beneficiaries so that they do not become losers (Leman, 1980).

Perhaps more important than its potential impact on any specific set of policy outputs, however, are the implications of blame avoidance for the theory and practice of democracy. More specifically, it has implications for at least two constraints that proponents of economic analysis of politics have outlined to an efficient transmssion of citizen preferences into government action. The first is that information is costly to obtain (Downs, 1956: chapters 11–13). As a result, most citizens do not in fact have a very good idea of what candidates' and officeholders' positions and records are. Second, because of 'free rider' problems, not all interests are likely to be equally well represented – and thus equally influential in decisions (Olson, 1965). On each of these points, the blame-avoiding perspective suggests both some good news and some bad news.

On the question of information costs, the good news is that political entrepreneurs (both interest groups and candidates) have strong incentives to purvey information about their opponents in a way that imposes

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as few costs as possible on voters, believing that this information-giving function will provide a substantial return on their investment. On the other hand, this information will be very biased toward the negative, and may contain substantial distortions. In addition, fear of blame causes politicians to be vague in their issue positions, especially where constituencies are divided. Thus voters are denied full information on which to make their choices (Page and Brody, 1972: 995).

On the question of free rider constraints to formation of groups, the good news suggested by the blame-avoiding perspective is that individuals facing major losses probably don't have to be well organized to have attention paid to them. Officeholders are likely to anticipate constituency losses and work to avoid them, since they recognize their dire consequences. On the other hand, the theory of blame avoidance suggests that some groups' views – those that are threatened with losses – will be weighted more than the views of others, because potential losers are more likely to be vocal in expressing their views. It suggests that a Paretian view of the proper role of government (that it should maximize public welfare only when doing so does not make some individuals worse off) may have some empirical grounding, irrespective of its ethical validity. For government will be fearful of trying to maximize net social welfare when doing so forces losses on some interests.

NOTES

1. David Mayhew (1974: 52–61) argues that credit-claiming is not a strategy that legislators can engage in on all issues: the claim must be credible. This is possible only if (1) legislators can show that they were 'prime movers' in the adoption of a measure – e.g., a sponsor or member of the legislative committee with jurisdiction over the issue, or (2) the benefits are particularistic, handed out in an ad hoc fashion, with the legislator playing a role in their distribution. He contrasts this with 'position-taking' – issuing a public judgement on an issue, most notably through roll-call votes. The term 'credit-claiming' is used here in a broader sense than in Mayhew's book, to include position-taking when it is done in the expectation of political gain rather than to avoid political losses.
2. Constituency costs and benefits are rarely weighed equally by politicians for a third reason, even if they are equally concentrated. If either costs or benefits fall disproportionately on a group that is unlikely to vote for the officeholder in any case, they will be discounted heavily; the same is true for groups that are unlikely to be shaken from support for the officeholder.
3. For a discussion of why voters are likely to give a higher weight to negative than to positive information, see Lau (1985) and Fiorina and Shepsle (1986).
4. Using both aggregate and individual level data, Hibbing and Alford found that the effects of retrospective economic voting in House elections are limited to races in which an incumbent of the President's party is running. Tufte (1978: 126) has disputed the absence of positive electoral effects of an economic upturn, at least for years of very good economic performance. Tufte also notes that party identification affects how individuals perceive changes in their family's financial situation (p. 130).
5. Constituents will be used here in a broader sense than simply voters in a legislator's district. It includes potential campaign contributors and elites in interest groups with links to the legislator's electoral constituents as well.
6. This choice, as well as a vote for the status quo in Cell 2, can also be seen as extreme cases of a blame-avoiding situation: the costs of a contrary vote are so overwhelmingly negative that this

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option is not even considered. But the more parsimonious explanation is obviously to focus directly on credit-claiming.

7. This list is not intended to be exhaustive. It is limited, for example, to strategies that are likely to affect future policy choices. It thus excludes strategies that are limited to deflecting blame for past policy choices, but are unlikely to affect future ones.
8. For a similar analysis that stresses universalism in legislative decisionmaking as a form of insurance for a steady stream of benefits, see Shepsle and Weingast (1981). Their analysis, however, focuses only on the provision of benefits and does not directly address the question of their political implications, notably the casting of blame by future political opponents if those benefits are lost.
9. Jackson (1968) found that British MPs were seldom successfully punished for rebelling against the Whip, but that they were less likely to receive rewards such as foreign trips, advancement to ministerial posts, peerages, etc.
10. The economic analogy is to entry into potentially competitive markets with substantial but not insurmountable entry barriers. A firm operating in those markets can gain some monopoly profits, but attempts to exploit them too far will lead to a challenge to their position. Just how large those profits will be depends on the nature of entry barriers. Similarly, the ability of a clientele and its governmental allies to exploit a policy-making monopoly depends on how easily latent checks and counter-clienteles can be mobilized, which in turn depends on barriers to information and organization by those groups.

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Putting Monetary Policy in its Political Place[1]

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ABSTRACT

Even though a central bank has formal independence, the success of its actions are part of an interdependent system of policies in which elected governments have a role too. In the making of monetary policy, economists have technical expertise but politicians claim electoral legitimacy. This paper examines monetary policy from the perspective of elected officeholders who must balance non-economic pressures, both domestic and international, against concerns of central bankers with monetary constraint. It emphasizes divisions within national governments about how that balance should be struck, and differences in political priorities for economic policymaking between countries and across time. It concludes with a POP (Politically Optimal Policy), having flexibility between multiple and shifting policy goals rather than fixing on a single target, monetary or non-monetary.

The big challenge to international and domestic monetary policies is to separate the economics from the politics. Often, unfortunately, the politics dominates.
Gary Becker, Nobel laureate in economics

No president has an economic policy; all his policies are political.
Richard E. Neustadt, author of *Presidential Power*

In theory, monetary policies can be discussed in terms of a single criterion, such as an optimal currency area or a winning election strategy. In practice, monetary policies are part of a multi-dimensional matrix of issues reflecting political and economic pressures both domestic and international. The attention give to monetary policy issues is asymmetrical. For elected politicians it is one among many concerns, and often outside their knowledge or experience. Central bankers can welcome being ignored by politicians, insofar as it increases their scope for independent action on a daily basis. But from time to time the interdependence of political and monetary issues forces bankers and politicians to confront common problems from contrasting perspectives.

The outcome of confrontations between politicians and economic

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actors is contingent on circumstances. German Chancellor Helmut Kohl forced the German Bundesbank to accept an overvalued rate for the East German Mark as the price the Federal Republic would pay (and is still paying) for German reunification. However, in 1992 pressures from the foreign exchange market broke the credibility of a newly elected British Conservative government (Stephens, 1996).

Every year sees elections in several EMU member countries.

> It is a crude fact – not recognised in the solemn declarations around the creation of the euro – that at election time most politicians care more about voters in the street than disapproving number-crunchers in EU office blocks. (Parker and Swann, 2002).

While there may be a consensus among politicians and economists about the desirability of price stability, it does not follow that there is agreement about whether preventing inflation is an end in itself or a means to an end. As Richard Neustadt emphasizes, for politicians all economic policies are means to political ends. When price stability is put in its political place, this subordinates it to such goals as keeping government colleagues together, winning re-election, financing social policies and maintaining national defence. However, in an era of big government the achievement of many political goals requires money; therefore, no politician can be indifferent to the state of the national economy, including monetary policy. This is true whether a loose monetary policy is seen as a means to the end of winning a forthcoming election, or whether a tight monetary policy is seen as the means for dealing with the inflation that can follow a loose monetary policy. While a national leader can give monetary policy issues a low priority, as Lyndon Johnson did during the Vietnam War and Richard Nixon did in subsequent White House discussions about the Italian lira, the consequences of ignoring inflation cannot be ignored.

Monetary policy is thus a *meta-policy* concern, reflecting diverse pressures from different departments of government, party and interest groups, from domestic and international markets, and increasingly from intergovernmental and international financial institutions. In the words of the Danish government's spokesperson on EMU:

> It is difficult to narrow the public debate down to only dealing with the EMU. We have to discuss broader issues, because this is what our electorate wants. (quoted in Marcussen, 2002: 144).

Given diverse and often conflicting pressures, a prime minister must set priorities between competing goods and reconcile conflicting demands in ways that avoid the loss of political support.

The creation of the European Central Bank (ECB) has altered the

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way in which monetary policy is made, and the circulation of the euro gives public recognition to new forms of monetary interdependence. But these events have not made monetary policy a consensus policy. There are disagreements about economic priorities within every EU member state; between member-states of the European Monetary Union; and between member-states and non-member states about whether or not it is in a country's political interest to belong to the Eurozone.

The constitution of the European Central Bank gives it a formidable degree of independence of national parliaments and elected politicians (cf. Issing et al., 2001; Chang, 2002). But removing the ECB from a national setting does not remove it from politics; it simply substitutes one set of political arrangements for another. To claim that the ECB is now governed by Platonic guardians removed from politics is to practice the politics of the apolitical, asserting power by ignoring political feedback (cf. Deutsch, 1963).

I Political makers of economic decisions

While national governments are the units that created the ECB, it is misleading to think of each national government as having a uniform view of what monetary policy ought to be. Since member states of the European Union are democratic, in every country Opposition parties have the right to enunciate an alternative view about economic policy. Opposition parties can use election campaigns to press for more liberal spending policies that encourage a governing party to make electoral commitments that could undermine its fiscal commitments to the ECB, as happened in the French elections in Spring, 2002. Alternatively, a newly elected government can seek absolution for violating Stability Pact provisions by blaming its predecessor for breaching ECB rules about deficits, as centre-right Portuguese Prime Minister José Manuel Durão has done. If a government is a coalition, as is the norm for all 12 member countries of EMU, partisan differences are likely to be articulated within government too.

The multiple policies of a government are the responsibility of multiple departments with different priorities, such as spending vs. saving or pump-priming vs. fighting inflation. In contemporary European states, spending ministries, such as health, education and social security tend to be introverted, focusing on domestic concerns. This is even more true of departments concerned with local government spending. Extroverted ministries with relatively low claims on the public budget but significantly concerned with international relations include foreign affairs, trade, industry, finance, energy and agriculture. Each depart-

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ment is headed by a politician with personal political ambitions and goals.

Major economic issues must go to the top of government. Whether or not the prime minister or Cabinet is capable of determining the outcome, they must accept responsibility for the consequences of economic processes to which their decisions are inputs of limited rather than controlling impact. Constraints of time, organizational resources and departmental structures limit a prime minister's involvement in policymaking to a few issues. The prime minister is concerned with meta-policymaking as the focal point for pressures from multiple government departments, domestic pressure groups and international pressures. He or she is also concerned with political management, that is, maintaining office by minimizing friction with political colleagues, having good media relations and opinion poll ratings, and winning re-election.

A prime minister has two unique balancing roles. He or she must balance economic and political pressures within government, such as Ministry of Finance advice and electoral calculations; and foreign and domestic considerations. A prime minister is better qualified to listen to and make judgments on meta-issues than on monetary issues. It is unusual for a professional economist to become prime minister and an academic degree in economics is no proof of a grip on the intricacies of monetary policy, as illustrated by Ronald Reagan, the first American president to have an economics degree, and George W. Bush, the first MBA president. The immediate incentives of a prime minister are to engage in foreign affairs. A side effect of the terrorist attack on the United States a few months before the launch of the euro is that it raises the stakes of foreign policy for European as well as American leaders at a time when inflation appears to be under control.

The traditional view of the priority between domestic and international concerns was summed up by United States Congressman Tip O'Neill in the epigram, 'All politics is local', for Members of Congress depend on voters in their local district for re-election. But national governments have a national constituency. Moreover, in today's open international economy many issues that concern national governments are 'intermestic', conflating international and domestic concerns (cf. Rose, 2001). The introduction of the Single Europe Market has greatly augmented the scope for regulations of the European Union to apply to what were formerly viewed by politicians as strictly domestic matters, and agreements to deepen the EU since have increased the number, visibility and impact of intermestic policies on national governments. Hence, any politician who follows President Clinton's prescription for winning a national election – 'It's the economy, stupid' – must heed what happens in the international economy.

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The European Central Bank is part of a complex of economic policymaking institutions, including national government as well as other European Union institutions. The 18-member governing council of the Bank consists of 12 members who are the heads of the central banks of member states, while 6 are executive board members based in the Bank's Frankfurt headquarters. While the ECB is meant to be "above" national political interests, the squabble over the nationality of the first ECB president was not a deviant case but the first example of a continuing concern of national governments with the nationality of the ECB's leaders.

The European Commission's supranational directorates collectively have broader terms of reference than the ECB and national central banks, and this is reflected in its statements on monetary policy. Pedro Solbes, the Monetary Affairs commissioner, has placed public pressure on the ECB to give greater priority to economic growth by being more flexible in stability policies that are only one of the two nominal goals of the Stability and Growth Pact. In advancing this view, Solbes is also promoting a claim for the Commission to have more influence on monetary policy. The European Parliament has the least power but it has a unique claim to legitimacy as long as it is the EU's only elected body.

National finance ministers can use Ecofin, the Council of Ministers committee of finance ministers, to advance national priorities that challenge rules laid down in Frankfurt. The Italian Finance Minister, Giulio Tremonti, has called for the ECB to 'reinterpret' its priorities as between stability and growth, yielding its former insistence on a completely balanced budget and excluding from its review of budget balance, at least for a period, government spending on economic reforms and investment.

> Balanced budgets were required in the first phase, when we were in the process of setting up the euro. Now we must try to move to another phase, one which maintains stability but also puts the emphasis on growth and flexibility (quoted in Blitz, 2002).

The European Commission has given France, Germany, Italy and Portugal more time to bring deficits into line with commitments entered into in the Stability and Growth Pact. Tremonti has welcomed this as moving 'from technocracy to democracy' (ibid.).

For member states of the European Union, major international financial institutions are less relevant for national policy. EU countries are ineligible for World Bank loans for economic development, and preparations for EMU were intended to prevent any European country from going to the International Monetary Fund for financial assistance, as Britain and Italy did in the 1970s. To date, the ECB has not become

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focus of attention from Non-Governmental Organizations (NGOs) that have protested and disrupted meetings of the World Bank, the IMF, G-7 and the World Trade Organization from Seattle to Gothenburg and Genoa, and placed on the agenda of international financial institutions issues very different than price stability. Yet logically, the ECB's monetarist policies are open to many of the criticisms that NGOs hurl at global financial institutions.

II Multiple, shifting and conflicting economic priorities

In reaction against the depression and unemployment of the 1930s, for more than a quarter century after the end of the Second World War the governments of Europe pursued policies that gave priority to economic growth and full employment. These priorities were relative, not absolute, for price stability and a favourable balance of payments were also valued. While governmental managers of the economy viewed Keynes' theory as making monetary policy instruments a means to economic growth and full employment, they were prepared to shift monetary policies when the pursuit of these goals threatened inflation or a balance of payments crisis.

In recognition of the interdependence between economic goals, most European countries developed formal or informal institutions intended to reduce conflicts or facilitate trade offs. In Austria, where a conservative-socialist coalition was the norm and posts in government were divided in proportion to party ties, the central bank, the spending and taxing departments of central government, the trade unions, and business interests could seek to coordinate policies in order to maintain a balance in pursuing a multiplicity of desirable goals. By contrast, the British government did this through "stop-go" policies involving increasingly large swings in interest rates. Many governments practised "one-eyed Keynesianism", that is, running a budget deficit when this was the appropriate Keynesian policy to promote full employment and continuing to do so when it was not. In the extreme, Italy ran a deficit for 25 consecutive years from 1951 to 1975, and over the years governments of both left and right more often had deficits than balanced budgets (Rose and Peters, 1978: 138ff).

The eruption of stagflation in the mid-1970s led to a major structural shift in the political priorities of economic policy. Double-digit inflation made price stability the primary political goal in societies where everyone was affected by high rates of inflation and fewer were directly or indirectly concerned about unemployment or low rates of economic growth. The revolution in economic priorities and paradigms was symbolized by the readiness of Margaret Thatcher to take responsibility

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for double-digit unemployment in the early 1980s in order to bring inflation down to a single digit number. It was confirmed by the failure of demand-stimulus policies pursued by François Mitterrand after his election as French president in 1981. The consistently low inflation rate of Germany became the beau ideal of economic policymakers. Given the monetarist bias of central bankers, an independent central bank on the German model became regarded as the best means of institutionalizing a strong commitment to price stability.

The European Central Bank was established in the 1990s by politicians who were reacting against the inflation of the previous decades. To say that the ECB was designed to fight the last war is an exaggeration, since money supply is an ongoing responsibility of government and global markets trade currencies around the clock. Yet its creation did reflect a rejection of earlier policies. Moreover, the establishment of the ECB was part of a process of strengthening European institutions against national institutions after the fall of the Berlin Wall and the re-unification of Germany in 1990, and it was consistent with goals of the Single Europe Market (cf. Dyson, 2002). When low rates of growth are evident in many Eurozone countries, growth can replace price stability as a political priority, but not as the priority of the ECB. Thus, there is a danger of one-eyed monetarism replacing one-eyed Keynesianism. Barry Eichengreen expresses 'a slight fear that the ECB looks at the world through a rear-view mirror' (quoted in Barber, 2001).

The creation of the ECB was the culmination of a sequence of events that have shifted political priorities greatly, but the shift has not meant the repudiation of such goals as economic growth and promoting employment. Preparations for entry to the European Monetary Union and, in the case of outsiders, debates about whether or not to join EMU focus attention on choices between competing priorities. The balance sheet of consequences invariably shows a mixture of costs and benefits – and in some cases the costs are short-term while the benefits are longer term. A mixture of consequences raises questions about the distribution of costs and benefits within as well as between countries. Interpretations can vary too. As Dodd (2001: 32) notes, 'Economic convergence is generally taken to refer to inflation in Germany but is more likely to mean income and growth in Portugal, Greece and Ireland'. Differences in interpretation are likely to expand with EU enlargement.

The clear and overriding priority of the ECB – price stability – strengthens the impact of its activities,[2] for '*organization is the mobilization of bias*. Some issues are organized into politics while others are organized out' (Schattschneider, 1961: 71; italics in the original). But the narrow focus of the ECB is a weakness when policymakers have multiple goals and institutions and shifting priorities.

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III Priorities across space

The first priority of an elected government is to its national electorate, a point that can be overlooked by officials of institutions that do not depend on popular election for their authority and legitimacy. Yet it is a *reductio ad absurdum* to claim that election enables government to do 'what the people want'. Once in office, elected governors quickly learn that, as a British Treasury minister once said to me, 'The laws of economics that we studied in school haven't been suspended just because we are in office'. On the other hand, it is the height of arrogance to claim, as a very senior British civil servant has done, 'the Treasury stands for reality'. In political economy, there is more than one reality. The foreign exchange market is itself witness to this fact, for in any given day's trading there are buyers and sellers, and losers as well as winners.

Governors of small countries are under no illusion about power relationships. While entry to office depends on national election results, economic success depends on what happens in the economy of Europe and internationally. By entering EMU, small countries such as Austria are no longer on the outside when decisions are made in Frankfurt by the *Bundesbank* of the Federal Republic. They gain an insider's seat at the table in Frankfurt when the European Central Bank takes decisions. Visibly shifting the locus of decisionmaking to a foreign country can appear, at least to many Britons, as a political debit, a loss of "sovereignty" or at least of the appearance of sovereignty. But in small countries, such as Austria and Ireland, the opposite argument can be made: membership in the ECB gives national officials a chance to be present when monetary decisions with a major impact on national policies are made abroad. The foreign locus of decisionmaking also creates opportunities for displacing or at least sharing blame when politically unpopular decisions are taken. National officials can criticize ECB decisions in their national political arena whilst acquiescing privately in Frankfurt. For a coalition government, passing monetary decisions to an intergovernmental agency avoids disputes that can disrupt a national coalition.

Governments of a country with a big displacement in international financial markets may act like a hegemon, imposing their national policies in ways reaping national benefits and externalizing costs. After a group of Harvard and Yale economists offered advice to the United States Secretary of the Treasury about how to deal with the international implications of the dollar going off gold in 1971, John Connally explained, 'Gentlemen, I look at it this way. Either those foreigners are gonna screw us or we're gonna screw them, and I want to be sure that

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we screw them first' (quoted in Odell, 1982: 263). Europe, however, has no financial hegemon. While the *Bundesbank* may be an institutional paragon to monetarists, the debilitating effects of financing five East German lands, combined with the slowness to adapt of the German economy, has deprived the largest economy in Europe of the resources to act like a hegemon. And Britain and France demonstrate that governments of large European countries have differed in assessing the advantages and disadvantages of membership in EMU.

From a global perspective, the euro is a regional currency along with currencies issued by the United States Federal Reserve Bank and the Bank of Japan. Moreover, the economy of its member-states makes it much bigger than Japan and it is similar to the United States in population and wealth. The euro can offer intra-regional currency stability, but not global stability. Another way of describing the position is that the euro is now vulnerable on two sides, for its value can be unilaterally influenced by what happens to the dollar and/or to the Yen. For countries such as Britain, which have a substantial tie to the dollar as well as to the Eurozone, there is now the risk of being hit by negative changes in both currencies, or seeing gains in one currency offset by losses in another rather than producing a win-win outcome.

From a global perspective, fighting inflation is only one among a multiplicity of concerns. When military action occurs, then the dominant actor is not in Europe but in Washington. The Gulf War of 1991 and September 11, 2001 were events with an absolute priority for political decisionmakers. When international security is the issue, then the primary security reference point is NATO, whose membership and power structure is very different from that of the ECB, for the United States is the hegemon in NATO but outside the Euro zone.

IV Priorities across time

'A week in politics is a long time' was the motto of British Prime Minister Harold Wilson. By contrast, a treaty commitment to the European Monetary Union is a very long-term commitment. The adoption of the euro as a country's currency makes national currencies such as the Deutsche Mark and the French franc part of the historic past. Moreover, it creates a great obstacle to reversion to the *status quo ante*, because, if a member-state decided to withdraw from the euro it would not be able to revert at once to the national currency that it has abandoned.

The contrast between the time span of a politician such as Wilson and treaty commitments emphasizes that the duration of the span of time chosen in evaluating currency zones is critical. A comparison of

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year-on-year rates of inflation or growth is very vulnerable to short-term fluctuations in economic conditions. As Rollo's (2002) comparison of the economic performance of Britain and Germany shows, a very long-term comparison over several decades tends to favour Germany, while a short-term comparison over the past decade tends to favour Britain.

A half century ago the founders of the European Coal and Steel Community, the precursor of today's European Union, did not justify the Community by econometric calculations of pecuniary costs and benefits. Instead, the case rested on a comparison with an all too familiar past, in which two world wars had been fought and lost in one sense or another by both Germany and France. On that basis, the Schuman Plan was adopted to integrate the materials of war in the belief that this would prevent the outbreak of a Third World War.

As long as the European Central Bank was an idea, any evaluation of its consequences was necessarily prospective and speculative, for there was no historic record on which to base a judgment. Judgments could draw on historical analogies, simulations based on data from the past and/or theoretical deductions, each of which is necessarily contestable. The situation offered a field day for politicians who wanted to impose their political values, hopes and fears upon a fluid situation. It also offered great scope for theoretical economists who could deduce consequences from first principles without risk of evidence contradicting their conclusions.

Even after the euro has gone into general circulation, it is still too early to tell how much difference the new currency makes to national economic performance. Insofar as unexpected events have an impact, then after half a dozen years or more evaluations of the euro's impact will be qualified by a *ceteris paribus* clause that ignores the fact that all other conditions have not remained equal. Even after a period with no eventful interruptions, analysis of the effects of the ECB must involve comparison with a speculative notion of what national economic performances would have been in the absence of EMU.

The powers that the ECB was endowed with in order to give credibility to the euro at its launch have created a situation in which future developments are more likely to threaten than augment these powers. Incipient conflicts are already evident between the priorities and performance of national governments and standards for price stability. Differences between the German government in Berlin and the European Central Bank in Frankfurt are particularly striking, in view of the Germanic foundations of the EMU system.

The enlargement of the European Union will bring in Central and East European countries that have not had the experience of current

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EMU members in balancing conflicting political and economic pressures in a democratic market system. Admitting up to ten or more countries will increase the size of ECB committees in which all member countries are represented (cf. Baldwin et al., 2001). The one populous enlargement country, Poland, cannot claim an impact on the European economy comparable to large EU member states (cf. Kokoszczynski, 2002). Even if the numerical representation of smaller countries becomes limited in executive committees, the greater the number of new members, the more difficult it will be to render them voiceless. Insofar as current discussions about institutional reform alter the European Union, whether making the Council of Ministers more powerful, strengthening the European Commission or creating an elected EU president, this will strengthen countervailing forces that can be brought to bear against independent decisionmaking by the ECB.

V What would a Politically Optimal Policy (POP) be like?

The readiness of economists to pronounce on the characteristics of an optimal currency area (OCA), whether that of a single country or a multi-national trading bloc, is encouragement to outline a Politically Optimum Policy (POP) for the government of an EU member-state. From the foregoing, it would:

- Deliver short-term benefits, whatever the long-term costs, for it is easier for politicians to get agreement about immediately visible benefits than to secure assent to paying immediate costs in return for hypothetical future benefits – especially if benefits accrue after rather than before a general election.
- Juggle multiple goals – political AND economic – for the priorities of politicians alter with the political situation, for example, the proximity to an election, as well as with the economic situation. From this perspective, an independent bank is *un*desirable, insofar as it avoids engagement in multilateral negotiations leading to trade offs that accommodate competing policy goals.
- Allow "fudging" the numbers by which a country's economic performance is evaluated so that when facing difficulties a national government can accommodate multiple political and economic priorities. This is already happening. In its February, 2002 *Monthly Bulletin*, the ECB expressed worry that national governments were succumbing to the 'temptation to improve artificially the current budgetary position by means of accounting measures that should be resisted'.

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- Make incremental and reversible choices, with policymaking proceeding on a trial and error basis, in which measures showing signs of progress can be maintained and those that are not abandoned (cf. Braybrooke and Lindblom, 1963). An incremental approach to policymaking rejects commitments to a single goal and holistic plans without regard to feed back indicating progress or failure.

The hallmark of a politically optimal policy is *flexibility* in relation to the pursuit of multiple goals in an ever-changing political and economic environment. By contrast, the key characteristic of the monetary policy of the European Central Bank is a *fixed* commitment to price stability in all circumstances. This is shown, for example, in its inflation target being a ceiling which only tolerates undershooting rather than a symmetrical target permitting an equal amount of going above and below the target. In a larger context, a fixed commitment to a single economic goal fails to be politically optimal, when the aims of economic policy are multiple and, as Neustadt reminds us, public choices about the economy are above all political choices.

NOTES

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2 Compare the description of a British monetary economist as being like a 15-year-old who had invented the atom bomb and wanted to apply his new invention to everything in sight.

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Is the Euro Working? The Euro and European Labour Markets[1]

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ABSTRACT

Now that time has passed since the introduction of the euro as a commercial currency, it is possible to assess many arguments made in the abstract during the 1990s about European monetary union. This article shows that the euro zone still falls short as an optimal currency area in most respects. In particular, it undertakes an empirical analysis of the labour market and finds no progress toward flexibility or integration. These results challenge assertions of 'endogenous currency area' proponents that the euro area would become optimal 'after the fact', and that labour markets would serve as the principal avenue of adjustment. Instead, a 'rigidity trap' has developed in the euro area, consisting of relatively tight monetary policy, forced fiscal consolidation, and a risk of deflation in some economies. These conditions have compounded the difficulties of structural adjustment in European labour markets.

The track record of the euro has been varied since its introduction as a commercial currency in 1999. The actual launch of the euro was successful. Despite the daunting logistical challenge of changing the currency of three hundred million people, the twelve countries participating in the European monetary union (EMU) managed to handle the transition to the euro between 1999 and 2002 smoothly and efficiently. The new clearing system of the European Central Bank (ECB) has worked well. The Economic and Financial Committee and the Economic Policy Committee, which the European Commission established to support the monetary union, have been performing effectively.

Although the users of the euro have certainly not become infatuated with it in the way that Germans did with the deutschmark in 1948, opinion polls have shown that it is at least accepted by an overwhelming majority (European Commission, Press Release IP: 03/1724, 15 December 2003). Consumers complained that merchants – particularly service-sector businesses – used the transition to the new

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currency as an opportunity to raise prices, but the aggregate data show no sign of a price spike owing to the adoption of the single currency. Central banks and private traders worldwide have been steadily diversifying their currency holdings by adding euros to their portfolios. A large share of the world's bonds is now denominated in euros. There are even anecdotal reports that the euro is already beginning to rival the U.S. dollar as the 'mattress currency' of central and eastern Europe (*Washington Post*, 14 December 2002).

The value of the euro has fluctuated significantly over its short life in foreign exchange markets. The currency was worth just under $1.20 when introduced on 1 January 1999. The euro then fell by almost thirty per cent, bottoming out at 85 US cents in April 2001. Yet by the end of 2003, the euro had reached a record $1.25. To be sure, such developments come as no surprise to economists. They are consistent with exchange-rate theory and three decades of experience with the U.S. dollar and the Japanese yen. The currencies of large economies with relatively little exposure to foreign markets fluctuate far more widely than those of small, open economies. The recovery of the euro did belie critics who had initially derided it as a weak currency.

At a more fundamental level, however, questions have been mounting regarding the performance of European monetary union. The European economy has not been doing well and there are suspicions that monetary policy may be a contributing factor. Germany has been mired in slow growth for some time, dampening prospects for much of the rest of Europe, yet real interest rates remain relatively high there. At the same time, inflation has been accelerating on the periphery of the new currency area. The European Central Bank has been attempting to strike a balance, but the end result has been a one-size monetary policy that fits none. The latter half of 2003 was particularly unkind to European monetary union. In September, Swedish voters decisively rejected adopting the euro. At the November 25 meeting of EU finance ministers, France and Germany engineered a 'suspension' of the enforcement procedure for nations running excessive fiscal deficits as defined by the Stability and Growth Pact (SGP). Are these problems simply transitory growing pains, or are they symptomatic of more systematic shortcomings with European monetary policy?

An essential part of the answer to these questions can be uncovered in an examination of the soundness of the underlying foundation of European monetary union. Specifically, is the euro zone functioning well as a currency area? This article first introduces the topic of the empirical assessment of European monetary union. Second, it reviews the economic literature on currency areas in order to assess the arguments about the viability of the euro and then synthesizes the literature to

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develop a set of metrics to assess the euro area's current level of optimality. Fourthly it undertakes an empirical analysis of the impact of the introduction of the single currency on labour costs. Fifth, it engages in an institutional analysis of the impact and prospects of European monetary union. Sixth, the study suggests an agenda for reform.

The analysis finds that the euro area still falls short of being an optimal currency area. Progress can only be seen in the areas of reciprocal trade and price convergence. Low levels of intra-European migration, and the absence of a system for cross-national fiscal transfer, place the burden of adjustment squarely on wage flexibility. The empirical analysis of the paper reveals, however, that no discernable progress has been made toward labour-market convergence. The absence of sufficient economic integration leaves the national economies within the euro area vulnerable to inadequate adjustment to asymmetrical shocks.

1. The economic literature: optimum and endogenous currency areas

The project of European monetary union sparked a renaissance of research in the economics of currency areas, particularly about optimum currency area (OCA) theory. Optimum currency area theory endeavours to determine when it is economically beneficial to use a single currency within a specified area (for the seminal milestones of OCA theory see: Mundell 1961; McKinnon 1963; Kenen 1969; Tower and Willett 1976; Emerson et al. 1992). OCA theory shows that the adoption of a single currency pays off when an area is highly integrated economically and has the capacity to adjust quickly to an asymmetrical demand shock. An asymmetrical shock occurs when one region within a currency area experiences a significantly different economic development than the others. For example, when the Cold War ended in the early 1990s, the U.S. government heavily reduced aerospace and defence purchases. This produced an asymmetrical shock in southern California, where the contracting sectors were heavily concentrated, sending the region into a sharp economic downturn. An asymmetrical shock can also be stimulatory. For example, the German government's economic policy decisions surrounding German unification in 1990 unleashed an expansionary asymmetrical economic shock in the European economy. If a currency domain does not have the capacity to adjust quickly to an asymmetrical shock, then a region experiencing one risks being mired for some time in either depressed or overheated conditions. Regional asymmetries in the capacity to adjust, which resemble an asymmetrical demand shock if structural differences across regions produce varied responses to an aggregate shock or even to just a common monetary policy, can also occur as a result of a monetary union (Dornbusch, Favero and Giavazzi 1998; Franzese 2000).

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In practice, most OCA research since the early 1960s has engaged in specifying and testing individual avenues of cross-regional adjustment. This work has produced widespread consensus regarding the relevant properties. These are (Mongelli 2002: 8–10): (1) Extent of reciprocal trade; (2) Diversification in production and consumption; (3) Mobility in the factors of production; (4) Convergent inflation rates; (5) Political integration; (6) Price and wage flexibility; (7) Similarity in business cycles and the absorption of symmetrical shocks; (8) System of fiscal transfers.

Scholars have stressed business-cycle convergence, factor mobility (especially labour mobility), fiscal transfers, trade integration, and price and wage flexibility.

Although analysts have made progress in operationalizing most OCA properties, efforts to move beyond a list to produce an articulated model have proven far more difficult. Even one of the most sanguine observers concedes, 'There still is no simple OCA-test with a clear-cut scoring card' (Mongelli 2002: 5) Empirical assessments of past, present and potential OCAs remain patchwork and not always conclusive. Nonetheless, the attributes listed above at least provide a rough-and-ready means to take stock.[2]

When European monetary union began to move from proposal to policy during the 1990s, scholars also began to investigate a second question: How does the actual creation of an OCA affect its subsequent viability? By the latter half of the 1990s, two views had emerged. Paul Krugman developed one perspective that has come to be known as the 'specialization hypothesis'. This argument – based on trade theory and the experience of the United States during the twentieth century – postulates that the introduction of a single currency should result in greater geographical specialization since it promotes greater economies of scale and reduces the transaction costs to trade. The outcome would be greater regional specialization, which tends to produce both a decline in the correlation of cross-regional incomes and an increasing vulnerability to asymmetric shocks, perhaps even to a point at which participation in a single currency area would be economically deleterious for some regions (Bayoumi and Eichengreen 1996; Krugman 1993; Krugman and Venebles 1996; Tenreyro and Barro 2003).

The proponents of the second perspective, which has been dubbed the 'endogenous currency area' (ECA) argument (alternatively, the 'self-validating currency area' argument), regularly invoke the Lucas critique (which has served as a foundation of the rational expectations school) and assert that the creation of a currency area can *itself* induce changes that actually enable the participating countries to achieve a sufficient degree of integration along the OCA properties *ex post* to make a currency area viable, even if they had not been able to cross the threshold of optimality

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ex ante (Lucas 1972). ECA proponents argue that greater optimality arises because adopting a single currency typically has expanded trade dramatically with other currency union members (e.g., Alesina, Barro and Tenreyro 2002; Frankel and Rose 2002; Rose 2002). Some go one step further to assert that closer trade links promote more tightly correlated business cycles, which results in additional optimality (Artis, Krolzig and Toro 1999; Corsetti and Pesenti 2002; Frankel and Rose 1997). Other ECA advocates argue that currency unions inevitably produce political commitments and restrictions that also contribute to inducing sufficient optimality after the fact (Issing 2000).

The search for evidence of adjustment within the euro area has taken several forms. Some scholars have assessed the European economy using all or some of the criteria spelled out above. Others have compared Europe to the United States, which until 1999 had been the largest currency area in the world (for the United States as an optimum currency area, see: Kouparitsas 1999). The following sections use both approaches to summarize briefly the latest findings.

2. *An assessment of the euro area using core OCA properties*

Does the euro area now exceed a threshold of adequate integration when assessed using the core properties of an optimal currency area? This section will review recent empirical studies of the euro area using five core OCA properties: trade integration, cyclical convergence, factor mobility, fiscal federalism, and wage and price flexibility. The answer, in brief, is that the euro area still falls short along several dimensions.

2.1. *Trade integration*

Some economists have argued that the act of creating a common currency area produces a substantial deepening of trade among the participants (e.g., Frankel and Rose 2002). Others have pointed out that indirect effects also play a significant role. The formation of a currency union typically prompts the participants to adopt a series of additional supportive measures that further reduce the 'border effect', which stimulates trade (Rogoff 2001). Moreover, in an era of highly mobile capital, it has become harder for participants to capture the benefits of a preferential trade arrangement without adding the 'corner solution' of monetary union (Artis, 2002).

During the 1990s, the euro area countries exported on average roughly one quarter of their output to each other. Intra euro area trade drifted upward slightly over the course of the last decade, moving from 22 per cent of gross domestic product in 1990 to 26 per cent in 1999 (Statistisches Bundesamt 2002). The project to complete the internal

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European market by the end of 1992 is a likely explanation for a significant share of the modest deepening of reciprocal trade within the euro area during the 1990s. Still, this proportion of intra euro area trade fell well short of United States interregional trade. In 2000, however, intra euro area trade as a per centage of GDP jumped to 30 per cent. This considerable surge in trade is consistent with the research of Rose and van Wincoop, who have estimated that the creation of a single currency area in Europe would result ultimately in an approximately 50-per cent increase in intra-European trade (2002). It should also be noted that price differences that cannot be explained by geography and other 'natural' factors have also begun to fall by some estimates (see more on this below), but by no means have been completely erased. This trend is consistent with a deepening of reciprocal trade.

A note of caution should be sounded, however. Some scholars have questioned Rose's robust assessment of the impact of a currency union on trade integration (e.g., Persson 2001. For a reply, see: Rose 2001). It is too soon to tell empirically whether the pace and direction of intra euro area trade found in 2000 data represent a secular trend. The worldwide economic boom, which peaked in 2000, also played a role in stimulating trade. Preliminary data show a modest reversal in trade integration within the euro area in subsequent years when the global and European economies softened. Taken as a whole, these observations indicate that at least some exporters are taking advantage of the new opportunities for expanded reciprocal trade within the euro area, but the persistence of price divergences shows that integration remains by no means complete.

2.2. *Cyclical convergence*

Over the last three decades, the business cycles worldwide have become more synchronized, particularly among the more affluent nations of the world (Kouparitsas 1998). There is some evidence of cyclical convergence above the general trend within the euro area, but convergence remains incomplete. Artis et al. (1999) and Krolzig (2001) report strong evidence of a common European business cycle among eight core participants in the European monetary union, but concede that the cycles have not been perfectly synchronized over the past two decades. A comparison with the United States, however, reveals far more regional integration than is found in Europe. An early analysis by Bayoumi and Eichengreen (1993) shows that the European Union economies are less correlated than the regions of the United States, and Bayoumi and Prasad (1996) show that region-specific shocks predominate in the United States whereas country-specific shocks dominate in the EU. Other studies document a bifurcation within the European Union between a more tightly synchronized

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core group around Germany (i.e., Austria, the Benelux countries and, by some measures, France) and the remaining EU members, which are less well integrated (e.g., Funke 2000). Taken together, all of these studies indicate that an integration of business cycles within Europe is underway, but that it remains uneven. Once again, the level of integration according to this criterion does not approach that of the United States.

2.3. Factor mobility

Another potential avenue of adjustment within a currency area is through the mobility of the two principal factors of production: labour and capital. Labour mobility is particularly important because in the European Union labour income is the equivalent of approximately two-thirds of the gross domestic product, and historically, the real wage has been downwardly rigid. European labour mobility unfortunately remains extremely limited, despite persistent differences in regional unemployment, the guarantee of 'the free movement of peoples' under the 1957 Treaty of Rome, and the commitment by a core subset of EU members in the 1985 Schengen agreement to remove all controls on their common borders. The Organization for Economic Cooperation and Development (OECD) reports that only 1.5 per cent of the European Union's citizens reside in a member country of which they are not nationals. Mobility within European countries is also comparatively low. Labour mobility defined as the per centage of the population that moves from one local labour market to another annually is two to three times higher in Japan and the United States than in Europe (OECD 1999). Several factors account for relatively low European labour mobility. These include cultural and language barriers, the non-transportability of welfare-state programmes (e.g., public pensions and unemployment insurance) across national borders, sizeable legal and financial impediments to establishing legal residency, often difficult and expensive housing markets, and citizenship restrictions on public sector employment (Bertola 2000).

Low labour mobility poses a formidable challenge to the successful maintenance of European monetary union. In the United States, interregional migration almost single-handedly eliminates virtually all short-term interregional variations in employment; but in Europe, immigration is at best weakly responsive to regional employment differentials (Blanchard and Katz 1992; Bentolilla 1997).

Let us now turn to the other mobile factor of production, namely, capital. To be sure, European capital markets are substantially more open and integrated than they were twenty-five years ago. As recently as the early 1980s, several European countries maintained formal exchange

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controls and cross-national investment was all too often a harrowing experience. Although the barriers across European capital markets have come down since then, it could not be said that either foreign direct investment (FDI) or financial markets in the European Union have become seamless. Intra-European foreign direct investment has accelerated, but serious barriers hinder fuller integration. A 1999 European Commission report found that in sectors comprising roughly half of the European economy, significant impediments impair FDI (European Commission 1999). The repeated failure of the European Union to liberalize the rules for mergers and acquisitions has also held back intra-European investment. As a result, even today, most European mergers and acquisitions – particularly in traditionally sensitive sectors, such as banking – remain national affairs (OECD 2002: 11).

The situation in European financial markets is similar to FDI. The most recent OECD country review of the Euro area, which focused on financial market integration as a special topic, concluded that progress has been made, but 'there is ample evidence that financial markets have some way to go before national demarcation lines will effectively disappear' (OECD 2002: 11). Technological and managerial advances have been the 'main drivers' of financial market integration, 'while national policies often acted as an impediment' (OECD 2002: 10). Other studies, such as the 2001 and 2003 reports of the European Union's Giovannini Committee, confirm a persistence of national barriers to European clearing and settlement. 'Barriers include mismatches in corporate law, taxes and information-technology platforms, as well as straight protectionism' (*Economist*, 12 April 2003). Gaspar and Mongelli show that the ratio between European current account balances and GDP per capita has risen recently, indicating a rise in the significance of net financial flows (as cited in Mongelli 2002: 20). Shrinking interest rate gaps and a decline in arbitrage opportunities in the EU also indicate an increase in financial integration (Issing 2000a). Yet, a 'home bias' in equity holdings and relatively low levels of cross-national ownership of assets remain the rule (Obstfeld and Rogoff 2000; Tesar and Werner 1995). A shift from reliance on local banks to securities markets for raising investment capital is underway, but progress is slow. Cross-border clearance and the settlement of commercial transactions are still 'cumbersome and costly', mortgage markets remain 'heterogeneous and domestically oriented', and 'entry barriers in local insurance and pension markets are considerable' (OECD 2002: 11).

To recapitulate, European labour mobility is quite low, which greatly complicates the smooth functioning of the euro area's economy. European capital markets have become more integrated over the past two decades, but remain far from unified. In the absence of major reform, the

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capacity of either factor to serve as an adequate conduit for quick adjustment in response to an asymmetrical demand shock is minimal.

It is worth noting the observation of Krugman and Obstfeld that if the current uneven trends in the factor-market integration persist, the cost of adjusting to a demand shock for some parts of the euro area could actually be higher than it was before monetary union (2003: 629). The combination of an immobile labour force and a decline in local demand within an integrated euro-area financial market could produce local capital flight that would result in regional pockets of persistent unemployment that would be even greater than job losses resulting from lost efficiency had the national government in question resorted to capital controls.

2.4. Fiscal transfers

Cross-regional fiscal transfers play an important role in promoting quick adjustment to asymmetrical shocks in the United States economy. Citizens in states with relatively weak economies pay relatively less in federal taxes and receive relatively more federal transfer payments in the form of social benefits and unemployment insurance than they would if their economies had been performing better. Ultimately, the citizens from states with stronger economies pick up the tab through the greater volume of taxes they pay and fewer benefits they receive from the federal government as a result of a strong economy. Besides speeding adjustment, fiscal transfers play an important role in the United States and other economies in keeping regions from diverging too far from each other economically (Obstfeld and Peri 1998; Sala-i-Martin and Sachs 1991).

The European Union is presently unable to construct a similar system of cross-member fiscal transfers for two reasons. First, each EU member runs its own independent set of transfer payment programmes that do not permit fiscal transfers across borders. In other words, if the German economy stagnates, German officials cannot tap into bulging Irish state coffers to cover mounting unemployment and welfare claims. Widely diverse rules regarding the structure of payroll taxes, eligibility and payments all but precluded an easy merger of national entitlement systems. Second, the member nations have severely restricted the size and the uses of the EU budget. The size of the total EU budget has been capped at less than 2 per cent of the EU's GDP, which is wholly inadequate for the purpose of cross-regional stabilization. Besides, the largest expenditures in the EU budget – agricultural subsidies and structural funds – are ill-suited to play the role of counter cyclical stabilizers. The absence of any means to undertake large-scale cross-member counter-cyclical fiscal transfers leaves euro area policymakers

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without anything equivalent to this second major mechanism for cross-regional equilibration relied upon by their American counterparts to preserve balance within the U.S. currency area.

Mongelli has argued that supranational transfers may not be necessary so long as national fiscal stabilizers prove up to the task of speeding adjustment to adverse shocks (Mongelli 2002: 23). This, however, presupposes that shocks never manifest asymmetries larger that what could be handled via transfers at a national level. This assumption could well be problematic, in particular for the smaller EMU participants.

2.5. Price and wage flexibility

Flexibility in nominal wages and prices promotes relatively speedy adjustment to an asymmetrical demand shock because it permits the transmission of the new information regarding relative scarcity.

There is general consensus that cross-national price segmentation has declined in Europe over the last twenty years as a result of the single market reforms. Still, deviation from the law of one price remains. Incomplete implementation of the single market programme, continued use of subsidies and the persistence of residual non-tariff barriers (e.g., infringement on mutual recognition, excessive fees for cross-border money transfers and domestic bias in public procurement) have preserved price differentials. Krueger and Pischke (1997) have argued that restrictions on product market are a far greater source of Europe's employment problems than labour market rigidity. In a few sectors, such as automobiles, price distortions are particularly severe. The pre-tax price differential on some models exceeds 80 per cent and even in the most open and competitive of sectors, such as consumer electronics, price distortions persist. A recent study by Beck and Weber (2001), however, finds that European monetary union has reduced inter-European price dispersion significantly, but national practices are still 'important determinants of price volatility'.

Turning to labour costs, analysts concur that within the euro area, real wages have traditionally been rigid (Blanchard and Wolfers 2000; Nickell 1997; OECD 1994). Wage setting has been predominantly a national matter, often taking place at the sectoral level. Patterns of wage determination and adjustment can differ considerably from country to country (Cadiou et al. 1999). For many years, wage flexibility has been a focus of much of the debate over the viability and the impact of European monetary union (Eichengreen 1993; Dornbusch, Favero and Giavazzi 1998; Feldstein 1997; Viñals and Jimeno 1996). Given the absence of adequate migration and fiscal transfers – which are the two principal elements that sustain balance within the U.S. currency area – and

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less-than-full integration of intra-European trade, business-cycles and capital markets, wages stand out as the pivotal vector of adjustment for sustaining stability in the euro area. Conventional wisdom has it that without increased flexibility in labour markets, the euro zone cannot avoid plunging into a 'Mundellian nightmare' of asymmetric growth with simultaneous pockets of overheating and stagnation (Dohse and Krieger-Boden 1998).

Lars Calmfors (2001: 8) spells out the causal mechanism through which, at least in theory, EMU could induce an endogenous increase in wage flexibility. To the extent that European monetary unification leads to product-market integration, product-market competition will intensify. Once a single currency is introduced, firms in countries with relatively high costs for a given sector within the currency area, which had previously been shielded by the transaction costs resulting from separate currencies, would come under unprecedented pressure to restructure. One substantial area for economies would be the wage bill.

Sceptics, such as Krueger, counter that one should not underestimate the willingness of societies to accept higher unemployment to preserve generous compensation arrangements and welfare states. This certainly has proved to be the case through much of Europe over the last thirty years. Krueger points out that demand for the protection of workers from market swings is even likely to increase, since monetary union raises the level of economic volatility. The greater demand for security, Krueger argues, is likely to cancel out rising calls for deregulation from other quarters of the economy, leaving things at the *status quo* (Krueger 2000).

Krueger sees a relaxation of product market restrictions and limits on entrepreneurship as a more politically popular means to induce greater flexibility to the euro area than labour market liberalization. Yet Krueger never explains how labour costs could be largely insulated from the pressures of increased product market competition. Evidence from a recent series of OECD studies demonstrates a tight connection between the product and labour markets. Consequently, product market deregulation would most likely produce a second avenue of pressure for labour market flexibility rather than a substitute for it. Still, Krueger's observation regarding the exceptional stickiness of European labour markets and his explanation for it, which is rooted in voter and interest group preferences, remains worth considering (Krueger 2000; Jean and Nicoletti 2002).

In the end, the most obvious way to determine whether the arguments of the proponents of the endogenous currency area argument or the sceptics have merit is to undertake an empirical analysis. Since the debate surrounding the efficacy of EMU focused most heavily on the flexibility

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of labour costs as the fulcrum of adjustment, the following section focuses there.

3. Empirical investigation of labour-cost trends in the euro area

Now that more than five years have passed since the exchange rates of the national currencies of the countries participating in European monetary union were irrevocably frozen *vis-à-vis* each other, we have enough data to start analysing the impact of this momentous step in European economic integration.

If the endogenous currency argument were correct, one would expect to find labour market adjustment to have started already, given the politico-economic structure of the euro area discussed above and the preliminary evidence of some deepening of reciprocal trade and price convergence. The logic of ECA theory suggests that adjustment would unfold in two phases. First, national labour costs would go through a one-time adjustment to find a new equilibrium reflecting the elimination of the transaction costs and other *de facto* barriers that were a product of the old multiple currency regime. Calmfors (2001) among others argues that this short-run transitional period would produce labour cost convergence at the sectoral level because price competition would intensify, but there would be insufficient time to respond with productivity enhancements. Convergence would aggregate up to the national level, since it is unlikely that countries would intensify a Europeanwide division of labour over the short run by shedding whole sectors. Convergence, in essence, would be the short-run manifestation of greater labour market flexibility. Full labour-cost convergence would not be expected, however, since national productivity rates still vary significantly. A convergence toward a common unit labour cost (ULC), which does take productivity into account, could be expected.

Once short-run convergence had been achieved, one would expect a new equilibrium within which there would be considerable stability in the relative wage rates among euro partners. In this second phase, wage ratios would only vary in response to shifts in relative productivity among the euro area members and to any asymmetrical shocks that arise.

Since an initial convergence phase, if it is taking place, would undoubtedly take several years to run its course, an empirical investigation should look for evidence of movement toward greater cross-national compression in labour costs. This can be done by employing a t-test to ascertain whether there is a statistically significant difference in the standard deviations of dispersion before and after the introduction of the euro. This analysis uses two measures of labour cost to conduct the test: nominal hourly labour costs and unit labour costs.

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Raw standard deviations using nominal data pose an especially rigorous test for the null hypothesis (that is, the introduction of the euro has had no significant impact on relative national wage determination) because national inflation rates in the euro area converged around a relatively low level over the course of the 1990s. Convergence of national inflation rates at a lower mean rate would, all other things being equal, itself produces a smaller standard deviation in the nominal change in labour costs between the two time periods under examination. Hence empirical results using nominal data that fail to reject the null hypothesis would be particularly persuasive.

The available data series covers ten of twelve euro area countries from the first quarter of 1995 to the fourth quarter of 2002, and provides partial data thereafter. This sample is deemed sufficient, since the two countries with missing data – Greece and Luxembourg – have relatively small economies. T-tests were performed on standard deviations from the period beginning with the first quarter of 1995 and ending with the fourth quarter of 1998, and the period beginning with the first quarter of 1999 and ending with the fourth quarter of 2002. An initial t-test included all ten euro participants for which there are data. Portugal was dropped because it was acting as an outlier.[3] The result of the nine-country test does not permit a rejection of the null hypothesis, namely, that there is no statistically significant difference in the standard deviations of nominal hourly labour costs in the periods before and after the introduction of the euro.[4] Figure 1 illustrates the pattern of the statistical results.

European compensation developments exhibit considerable consistency. Although individual countries do trade places (e.g., Ireland rises and Italy slips), the spread stays stable throughout the nearly eight years for which we have data for most of the countries. The notorious 'stickiness' of nominal labour costs has persisted despite the introduction of the euro.

A t-test on unit labour cost data was also performed to assess the robustness of the results above. Since unit labour cost (ULC) data reflect the full tradeoff of producing in one location versus another, they are an excellent measure of convergence. The Organization for Economic Cooperation and Development has sufficient quarterly ULC data for the business sectors of six of the twelve euro participants: Austria, Finland, France, Germany, Italy and Spain. Together, these six states comprise 86 per cent of the euro area's gross domestic product. The ULC series begins earlier than the eurostat data on hourly labour costs. This permits a t-test on data not only before and after the introduction of the euro in 1999, but also 'stage two' in the process of European monetary union, which began in 1994. There is an argument for doing so, since this is the point at which potential participants in European monetary union were

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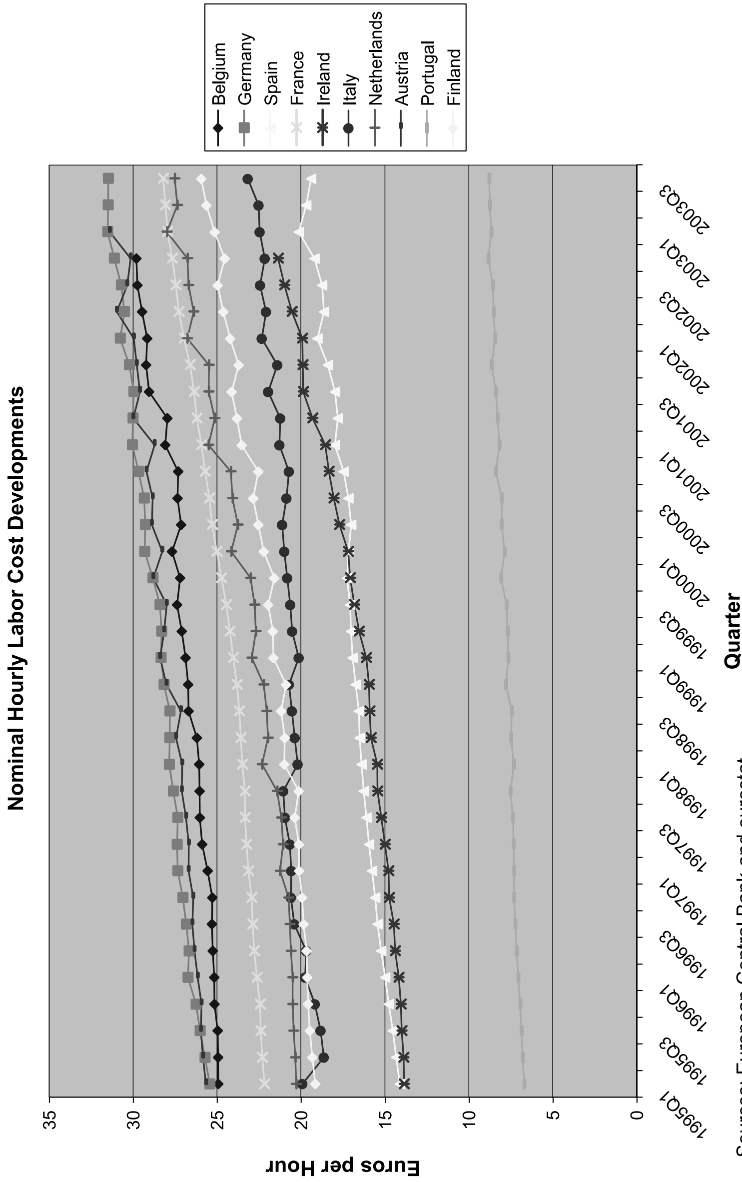

FIGURE 1: *Nominal hourly labour cost developments*

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obliged for the first time to pursue policies that would increase the convergence and coordination of their economies.

The null hypothesis is that the introduction of the euro has had no significant impact on the relative distribution of unit labour costs. Two t-tests were done on the standard deviations of the OECD's data on unit labour costs from the first quarter of 1991 to the fourth quarter of 2000. The first test separates the quarterly standard deviations in ULC into two populations, one covering 1991 to 1993, and the other 1994 to 2000. The second t-test sets the dividing point before and after 1999, as in the earlier t-test of hourly labour costs. Both tests do not allow a rejection of the null hypothesis, which for this data set is that there is no statistically significant difference in the standard deviations of unit labour cost in either the periods before and after the start of phase two in 1994, or the periods before and after the introduction of the euro in 1999.[5]

A visual inspection of Figure 2 is consistent with the statistical findings. The ULC data are more fluid than those for nominal labour costs. Spain, for example, rises disproportionately during the period under review, while Finland falls. Still, the standard deviation remains relatively consistent throughout.

Why are labour costs not converging in the euro area? Two potential explanations come to mind. First, five years may simply be too short a time for the impact of EMU to have worked its way through to the labour markets. As reciprocal trade increases and product markets converge, mounting price pressures may ultimately force policymakers and collective bargaining parties to institute labour market liberalization, but this all takes time. It is worth pointing out that since the introduction of the euro, Europe has not experienced an asymmetrical demand shock. Perhaps only the impact of this sort of shock will be powerful enough to break the *status quo* of wage determination, which is as much a product of politics as of markets. This may be the harsh reality of endogeneity when applied to labour markets. Still, after five years, waiting for change in the labour markets has become all too reminiscent of waiting for Godot. The case could also be made for a second scenario, namely, that we have already entered a Mundellian nightmare. While Germany teeters on the verge of deflation and a recession, inflation has been accelerating in Belgium, Ireland and Spain. By sticking to the middle course, ECB monetary policy has thus far proved inadequate to the task of resolving either problem.

The best way ultimately to sort out which scenario we are facing currently is to undertake a brief analysis of the institutional structure for national economic policymaking within the euro area. This architecture frames the universe and the relative advantages of the options available

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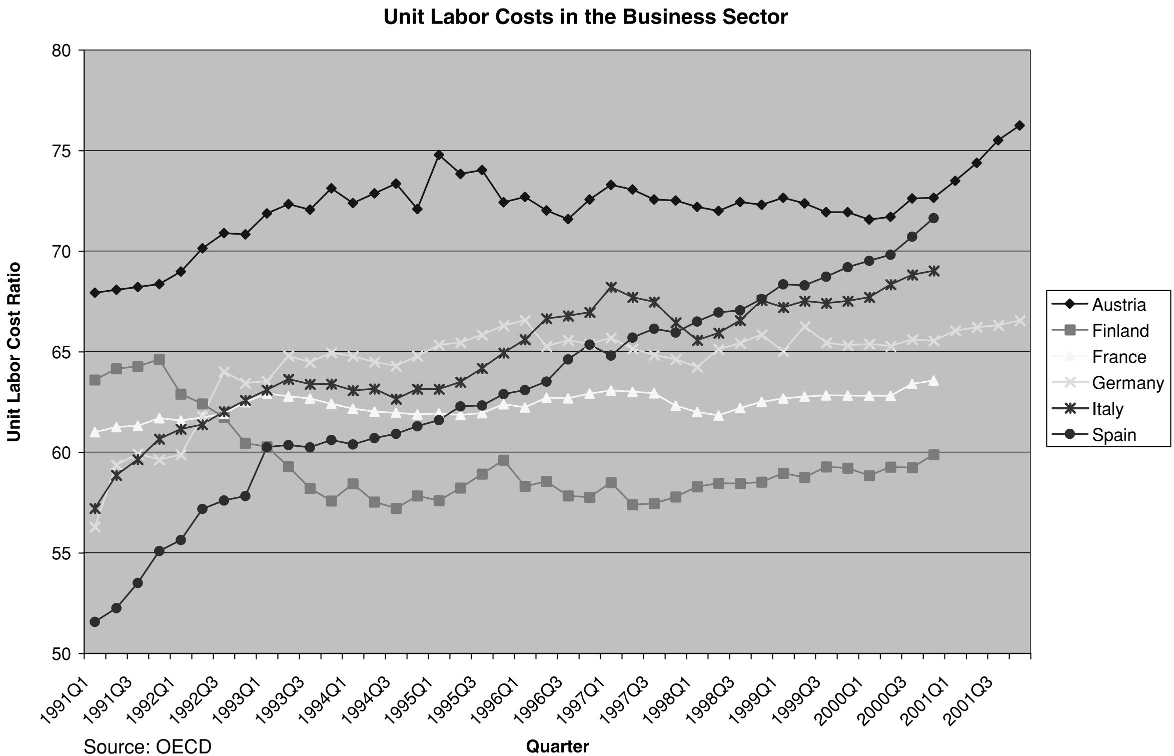

FIGURE 2: *Unit labour costs in the business sector*

to policymakers regarding European labour markets. The next section proceeds with that task.

4. An institutional analysis of European monetary union and impact on labour markets

Economic and political flaws within the institutional architecture of European monetary union have hindered the transformation of the euro zone into a single currency era. The Stability and Growth Pact, which was adopted at the EU Amsterdam summit in June 1997, is particularly problematic. The purpose of the SGP is to preserve the stability of the euro by establishing a means to dissuade participating countries from adopting inflationary fiscal practices. Specifically, the Stability and Growth Pact commits all EMU members to maintain a public budget ‘close to balance or in surplus’, and establishes an annual budget-deficit ceiling for each EMU member at 3 per cent of its gross domestic product. Violators of the deficit cap are to be subjected to a lengthy, multi-step process undertaken by the European Commission’s Directorate General for Economic and Financial Affairs that could culminate in a fine ranging from 0.2 to 0.5 per cent of GDP, depending on the circumstances. Only a significant economic recession (i.e., a GDP decline of at least 0.75 per cent) or a declaration of exceptional circumstances by EU finance ministers can forestall the penalty procedure (European Council 1997: 17–18; and Oudenaren 2000: 189).

The logic behind the Stability and Growth Pact rests on the assumption that poor fiscal policy choices and structural rigidities are the most likely root causes of an expansion of a public deficit (Barro and Gordon 1983). The SGP would then strengthen the incentive for violators to undertake structural reforms rather than simply attempting to spend out of an economic downturn. Ironically, however, the creation of the SGP may have made structural adjustment even more difficult. Chasing fiscal balance through tax increases and budget cuts in the midst of a weak economy, if pursued *in extremis*, can result in a ‘rigidity trap’. George Ackerlof and colleagues (1996) have observed that a low inflation rate (i.e., less than 3 per cent) limits the capacity for structural adjustment because it reduces the gap between the real and the nominal wage. Hence, if uncompromising fealty to fiscal probity results in a reduction of inflation to an extremely low rate, structural adjustment in labour markets becomes far more difficult because of the enduring stickiness of nominal wages (Walsh 1995).

There is considerable evidence that the euro area has landed in a rigidity trap. First, it is important to note that the European Central Bank has set 2 per cent as a ceiling for European inflation, which is well beyond

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the rigidity threshold observed by Ackerlof et al. Second, virtually every current participant in EMU had a structural budget deficit when they adopted the Stability and Growth Pact. Putting it into practice meant that they simultaneously had to cut their budget deficits to reach a balance, as required. When the world economy was booming, this was less of a problem. The onset of poor economic conditions in 2000 changed circumstances considerably. The downturn and the bursting of equity bubbles worldwide cut deeply into tax receipts. Accelerating unemployment increased government expenditures. These two trends combined to drive budget deficits above the 3 per cent ceiling in several EMU countries. Since the economic downturn was not sharp enough to trigger an automatic waiver of the penalty process spelled out in the SGP, the Directorate General for Economics and Finance has put several EMU participants under pressure to adopt pro-cyclical budget cuts and tax increases in the midst of a deteriorating economy and rising unemployment.

Circumstances could be worse. The decision of the EU finance ministers to suspend the application of the SGP penalty procedures to France and Germany has staved off an exacerbation of the rigidity trap and perhaps even a slide of Germany into deflation. Nonetheless, the November 2003 EU finance ministers' decision underscored the 'legitimacy trap' in the political architecture of European monetary union.

Chang (2002) argues that the independence of the ECB from elected policymakers leaves economic success as its sole criterion of legitimacy. This structural arrangement changes the relationship between the nation states and the ECB from one of principal and agent to collective responsibility. Unfortunately, the ECB's independence also means that the institutional arrangement needed to support a successful collective effort for delivering economic growth and price stability does not exist. Rose (2002) points out that the ECB's insulated position from national pressures and 'fixed commitment to price stability in all circumstances' is a 'weakness' because it is not readily compatible with the preference of elected officials with multiple goals and shifting priorities. The result is an adversarial relationship that has no constructive means of mediation. Attempts by national leaders to deal with immediate difficulties, such as a languishing economy, through concrete action can only be interpreted as a challenge to the legitimacy of European monetary union. Suspending the Stability and Growth Pact is not without its costs. This step puts into question the architecture of European monetary union, portending a rise in the risk premium of holding euros, which would force the ECB to increase interest rates. High rates would in turn dampen economic growth. In other words, incremental efforts to escape the legitimacy trap may only exacerbate it.

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5. *Implications*

More than five years into the monetary union, Europe is still not an optimal currency area. Although some progress has been made in terms of intra-European trade, business cycle convergence and price harmonization, the euro area remains far from integrated; its level of integration falls well short of that in the United States. As a result, Europe remains acutely vulnerable to an asymmetrical economic shock. European labour markets show no signs of becoming more flexible in the wake of the introduction of the euro. While most economists see increasing flexibility in European labour markets as the principal means to transform Europe into an optimal currency area, the patterns of relative unit labour costs and hourly wages have not changed. What are the implications for policymakers of this failure of the euro area to 'self validate'? What can be done to address the problems of a 'suboptimal' European currency area? The best first step would be to extend and maintain the suspension of the Stability and Growth Pact indefinitely. Its impetus and logic were always far more political than economic. The German finance minister, Theo Waigel, pressed for it to shore up political support for the euro at home. Yet, even without the Stability and Growth Pact, public and private dynamics already exist. Bond markets would discipline a profligate state through higher interest rates on their debt far more effectively than any political construction like the SGP well before any threat to the overall stability of the euro arises. Although the narrow spread on bond yields across the euro area may reflect at least in part a belief within private markets that the European Central Bank would monetarize the debt of any EMU participant that ran into serious structural difficulties, it is inconceivable that the ECB would monetarize debt without extracting a credible commitment to structural adjustment in exchange.

Secondly policymakers should simply concede that even under the most optimistic of scenarios, labour markets in the euro area are never going to become flexible enough to serve as the principal vector of adjustment for the currency area. To do so, the euro area labour markets would have to become even more flexible than those of the United Kingdom and the United States. The chances of such a dramatic transformation are at best slight.

The euro area remains vulnerable to asymmetrical shocks and varied national responses to aggregate economic disturbances. Using the euro as a battering ram to force through labour-market deregulation to create an optimal currency area has failed so far and is unlikely to work in the future. No other large currency area relies on wage flexibility as its principal vector of adjustment. Premising European monetary union on wage flexibility has proved to be little more than a pipe dream.

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NOTES

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2. Bayoumi and Eichengreen (1996) take a different approach in an effort to get around this problem. They use real and nominal exchange-rate variability as a proxy for the underlying economic determinants of optimality. Unfortunately, this method cannot be employed in the current investigation, since it can only be used to assess potential rather than existing currency areas.
3. When Portugal is included, the results of a two-sample, two-tail t-test assuming unequal variances are: t Stat = − 9.580; P(T < = t) = 4.08E-08. In other words, the results show strong significance and indicate an *increase* in the standard deviation after the introduction of the euro in 1999. The t-test is not robust, however. It turns insignificant when Portugal is excluded, indicating that Portugal is an outlier.
4. On a two-sample, two-tail t-test assuming unequal variances, the results are: t Stat = 1.697; P(T < = t) = 0.102.
5. On a two-sample, two-tail t-test assuming unequal variances, the results when the first quarter of 1994 is the dividing point are: t Stat = − 0.809; P(T < = t) = 0.431. The results when the first quarter of 1999 is the dividing point are: t Stat = 1.476; P(T < = t) = 0.151.

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To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy[1]

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ABSTRACT

Recent decades have witnessed the remarkable rise of a kind of market authority almost as centralized as the state itself – two credit rating agencies, Moody's and Standard & Poor's. These agencies derive their influence from two sources. The first is the information content of their ratings. The second is both more profound and vastly more problematic: Ratings are incorporated into financial regulations in the United States and around the world. In this article we clarify the role of credit rating agencies in global capital markets, describe the host of problems that arise when their ratings are given the force of law, and outline the alternatives to the public policy dilemmas created when ratings receive a public imprimatur. We conclude that agencies designated for regulatory purposes should be required to provide more nuanced ratings exposing their perceptual and ideological underpinnings (especially for sovereigns), and facilitating consideration of alternatives to ratings-dependent regulation.

> [I]t is annexed to the sovereignty to be judge of what opinions and doctrines are averse, and what conducing, to peace . . .
>
> Thomas Hobbes, *The Leviathan*[2]

The only legitimate judge of the security policies of a state was, for Thomas Hobbes, the state itself. The economic policies of states, however, have always necessarily been judged by the market, an abstraction universally understood as a collection of decentralized individuals and firms. It is standard, even cliché, to observe that political economy is based on the tension between the centralized authority of the government and the decentralized authority of the market. In this article we explore the public policy answers to a vexing question: How should governments respond when 'the market' is no longer decentralized?

The post-war years have witnessed the remarkable rise of a kind of market-based authority that is almost as centralized as the state

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itself – two credit rating agencies, Moody's and Standard & Poor's, which are based in New York but have an increasingly global reach. Through their 'opinions' on the creditworthiness of debt issuers, including sovereign governments, and the default risk associated with their bonds, rating agencies exercise significant and increasing influence over private capital movements (see Sinclair 2005). No sovereign government would dare to issue debt without being rated by one or both of the agencies. In fact, many sovereign governments have, without any intention of issuing debt, sought a rating as a signal of transparency and orthodoxy to the market and other governments.

The influence of the rating agencies has two sources. The first is simply the information content of their ratings, which is a combination of what Hall and Biersteker (2002a) describe as normative market authority and the moral authority of the non-state, non-self interested referee. The agencies' assessments of the likelihood of default thus derive, to a significant degree, from their objective analysis of the risks associated with a collection of macroeconomic policies before the backdrop of their subjective interpretation of the reigning orthodoxy. This first source of power is increasingly well understood by those who analyze the emergence of 'private authority' in the world economy (Cutler, Haufler, and Porter 1999; Hall and Biersteker 2002b). The agencies' sovereign ratings indirectly affect every other bond rating in the world because of the so-called 'sovereign ceiling'. With rare exceptions, private-sector issuers of debt cannot have foreign-currency credit ratings higher than their sovereign's (Abdelal and Bruner 2005a: 6–7).

The second source of the rating agencies' power is both more profound and vastly more problematic: Ratings are incorporated into financial regulations in the United States, as well as in many other countries around the world. A small number of rating agencies are literally, and legally, the 'gatekeepers' to the vast U.S. investing public. The U.S. government thus has put these unregulated firms in the position to express their interpretation of good economic policy to sovereign governments through the process of rating them, and the sovereigns are obliged to listen. EU countries have been on the receiving end of such policy dictates, and European parliamentarians have grown resentful of the perceived lack of understanding that the U.S.-based agencies have shown toward differing accounting standards and corporate financing customs. Ideas under consideration, on both sides of the Atlantic, include two opposite paths – regulating the rating agencies or eliminating the regulatory use of credit ratings altogether. Few policy makers seem to prefer the *status quo* of making unregulated firms so fundamental to the financial regulations that govern trillions of dollars worth of investments.

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The codification of this private authority has proven to be, at a minimum, politically and socially unpalatable.

At the very moment that regulators in the United States and Europe have undertaken investigations into the ratings industry, reevaluating whether regulatory reliance on their opinions is either prudent or politically sustainable, G10 central bankers and finance ministers have been busy finalizing a vast extension of ratings-dependent codes through the new capital adequacy rules for banks called 'Basel II'. Revisions of national laws may be undoing the codification of the agencies' influence just as the new international standards for banking are poised to magnify the effects of credit ratings. These contradictory drives underscore that notwithstanding the practical and normative issues associated with regulatory reliance on credit ratings, abandoning them is another matter entirely.

Thus, the 'private' authority of the rating agencies is not so private after all. Governments have both valorized and codified their authority. Indeed, governments define the market for ratings and help to determine their influence. As John Ruggie observes, the scholarly literature has overstated the process of regulatory privatization, 'obscuring the fundamental fact that in many instances of ''private governance'' there has been no actual shift away from public to private sectors'. Instead, Ruggie observes, 'firms have created a new world of transaction flows that did not exist previously', and which could not have come into being without a new 'global public domain' of transnational discourse (Ruggie 2004, 503–504). This is true for the bond markets, which are based, argues David Beers, Standard & Poor's Global Head of Sovereign Ratings, on a 'common language of credit risk that we at S&P helped to invent' (quoted in Abdelal and Bruner 2005a, 1). The agencies created a new way to talk about credit risk. Investors adopted it as a simple code through which to describe and grapple with the uncertainties inherent in investment. Regulators saw the agencies' analysis as a straightforward, putatively objective framework for the regulation of financial institutions' exposure to credit risk. And issuers came to see the agencies as points of access to international capital flows. But all of this happened not because Moody's and Standard & Poor's usurped the authority of states; instead, the agencies created something new, and governments consented both implicitly and explicitly.

In this paper we seek to clarify the role of credit rating agencies in national and international capital markets, and to describe the host of problems that arise when their ratings are given the force of law through incorporation into financial and prudential regulation. We argue that given the degree of reliance the markets and regulators place on credit ratings, and the lack of clarity regarding workable market-based

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alternatives, a more measured approach to these problems should be crafted and pursued, in place of the extreme responses currently receiving attention. Agencies designated for regulatory purposes in the United States (and elsewhere) should be required to provide ratings in a more nuanced format that permits users to distinguish, to the extent possible, between so-called 'quantitative' aspects based on fundamental economic analysis and so-called 'qualitative' aspects flowing more directly from the analyst's perception and ideology. By augmenting the informational value of ratings rather than abandoning them wholesale, a number of practical and normative issues can be managed while longer-term alternatives to ratings-dependent regulation are identified and evaluated.

Credit ratings and private capital flows

While various precursor institutions of the 19th Century provided industrial reports and even information on the creditworthiness of particular businesses, credit 'ratings' as such were an innovation of the early 20th Century, and specifically a response to modern industry and its massive appetite for private capital. The precursors of today's Moody's and Standard & Poor's initially issued ratings solely for the debt obligations of the railroads, which had catalyzed the development of a global bond market to finance their expansion (Sylla 2002: 19).

Throughout their histories, the major credit rating agencies' fortunes have risen, fallen, and risen again in tandem with private capital flows – initially within the United States, and later globally. From their origin in 1909 until about 1930, as Richard Sylla has observed, the agencies grew as the bond market expanded from railroad bonds to include issues by utilities, manufacturers, and sovereign governments. Investors used ratings to sift through the growing number of issues, and the agencies were largely thought to have performed well, endeavoring to establish and maintain strong reputations in a competitive environment through ratings sold to subscribers (Sylla 2002: 33–34). After World War II, however, the agencies declined in inverse proportion to growing economic stability. By the early 1970s the agencies employed few ratings analysts and depended on research reports for revenues (Partnoy 1999: 646–647).

The agencies' spectacular expansion since the 1970s has, again, effectively mirrored the growth in private capital flows over recent decades. Among the issuers that have taken part in the rapid expansion of the global bond market are a growing number of sovereign governments. The agencies have depended, perhaps paradoxically, on some instability in sovereign bond markets: Crises and defaults increase the

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potential value to investors of the agencies' expertise at the same time that they threaten to dry up the market or expose agencies to criticism.

Demand for sovereign credit ratings – particularly for high-yield, speculative-grade emerging-market bonds – has increased substantially since the early 1990s, when so-called 'Brady bonds' (essentially defaulted emerging-market bank debt repackaged as bonds) 'whetted investor appetites for high-yielding emerging markets securities, just as developing countries coming out of their 1980s recessions sought lower-cost, longer-term alternatives to bank loans' (Murphy 2000). Standard & Poor's, for instance, rated 30 sovereigns as of 1990, virtually all of which were investment grade, but by early 1998 that number had grown to 74 with an increasing number of speculative grade sovereigns, and by March 2004 had reached 100 with the help of a UN-funded program to introduce sovereign ratings to sub-Saharan Africa (Chambers and Beers 1999; Beers 2004; S&P 2004). Moody's issued 65 first-time sovereign ratings between 1991 and 2002 to reach a total of 100 rated sovereigns (Levey and Komanovskaya 2002). This trend reflects the fact that sovereigns in some instances seek ratings not because they contemplate debt issuances, but in order to communicate their commitment to transparency and efforts to achieve stability, and thereby (hopefully) to gain 'stamps of approval' from international capital markets (Vandemoortele 2004; also see Beers 2004).

The changing business model of rating agencies

The business model adopted by the rating agencies over recent decades differs markedly from that in the period of their origin, as does their position in today's capital markets. Whereas credit ratings initially were financed through subscription fees paid by investors, the dominant rating agencies today derive their revenues principally from issuer fees, creating an inherent conflict of interest that is only exacerbated, according to the agencies' critics, by the extension of the ratings franchise to the provision of ancillary services (Morgenson 2005; *Economist* 2005a; *Economist* 2005b). The agencies claim (very plausibly) that given the non-excludability problem reflecting the 'public good' nature of the product, issuer fees (which in any event can be passed on to investors through lower returns) are the only way to make credit rating a viable business (Partnoy 1999, 653). Even reluctant issuers will likely choose to pay for a rating – regardless of whether they wanted it – in order to have 'the opportunity provided by the formal ratings process to put their best case before the agencies' (Cantor and Packer 1995, 15). The potential for abuse is obvious, and the agencies have sought to defuse criticisms through various internal processes and procedures, including merit-based pay for

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analysts and 'firewalls' separating them from consulting work and fee negotiations, asserting that reputational concerns are sufficient to check such temptations (Smith and Walter 2002, 289; SEC 2003a; *Economist* 2005a; *Economist* 2005b).

A more fundamental difference in the ratings industry, however, has resulted from financial disintermediation, and the increasingly central role that a small number of prominent rating agencies have come to play in capital markets as they step into the information-gathering role previously played by banks. Traditionally banks have taken in money from depositors (the banks' creditors), and then lent it to borrowers based on their own credit evaluations, and at their own risk. Since the 1980s, however, banks have been marginalized from this process as depositors have put their money elsewhere and borrowers have found other sources of capital (mutual funds, for instance). As banks have retooled to become 'active market participant[s]', rating agencies have stepped in as informational intermediaries between those investing and those seeking capital, giving them substantial influence over private capital flows (Sinclair 1994, 448, 451; also see Sinclair 2001).

Finally, today's ratings business differs markedly as a result of the incorporation of credit ratings into financial and prudential regulations, both in the United States and elsewhere. While regulators in the United States have used credit ratings as benchmarks for limiting exposure to credit risk since the early 1930s, such regulatory use of ratings has greatly expanded in scope and significance since the SEC coined the concept of 'nationally recognized statistical rating organizations', or NRSROs, in 1975 (BIS 2000, 54; SEC 2003a, 5–6). Effectively the SEC has recognized a small number of prominent rating agencies as NRSROs based, among other things, on their having been 'nationally recognized' in the United States as issuers of 'credible and reliable ratings by the predominant users of securities ratings', permitting financial institutions to count such ratings toward compliance with the wide range of regulations incorporating the concept (SEC 2003a, 6, 9–10). (As of March 2005, the five NRSROs were Moody's, Standard & Poor's, Fitch, Dominion Bond Rating Service Ltd., and A.M. Best Company, Inc.) Similarly, the finance ministers and central bankers of the G10 have, in part, built their revised capital adequacy rules, 'Basel II', upon credit ratings. In effect, banks not in a position to undertake internal credit assessments (generally those with simpler loans and less sophisticated control structures) may opt to comply with capital reserve requirements based on ratings issued by so-called 'external credit assessment institutions', or ECAIs, identified by national supervisors based on criteria roughly similar to the NRSRO designation criteria (BIS 2004a; BIS 2004b, 23).

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The ratings marketplace

The market for credit ratings might best be characterized as a duopoly-plus-one (Smith and Walter 2002, 302). Moody's and Standard & Poor's, often called the 'Big Two', issue credit ratings on approximately U.S.$30 trillion worth of securities each (King and Sinclair 2003, 347; Moody's Corporation 2003, 4). In the 1990s, as demand for sovereign ratings increased, both agencies established cooperative relationships with numerous agencies in the developing world, and by the end of the 1990s, the Big Two accounted for 90% of the sovereign ratings market (Murphy 2000; Partnoy 1999, 650). Fitch is effectively a 'distant third' with some potential to achieve substantial market share, but presently lacks the coverage and reputation to compete with the Big Two (King and Sinclair 2003, 347). Numerous smaller players throughout the world are thought to bring the total to approximately 130 to 150 credit rating agencies worldwide (BIS 2000, 14–15).

While the Big Two emphasize their reputations and investor confidence in their ratings, characterizing the market as a competitive one in which issuers and users of ratings have simply voted with their feet, Fitch has emphasized 'Moody's and S&P's power in the current market', charging that they constitute 'a dual monopoly, each possessing separate monopoly power in a market that has grown to demand two ratings', and engaging in anticompetitive practices in areas of relative strength for Fitch such as structured finance (O'Neill 2003; Moody's Corporation 2003, 5–6, 28; Brown 2003). Indeed, some have argued that the incorporation of ratings into financial regulation has so altered the marketplace that the major incumbents effectively no longer rely on their reputations with investors. The 'regulatory license' hypothesis, as put forth by Frank Partnoy, posits that 'credit ratings are valuable, not because they contain valuable information, but because they grant 'regulatory licenses' vouchsafing compliance. As a consequence, it is argued, the major players flourish not because they enjoy strong reputations in the marketplace, but because ratings-dependent regulation creates artificial demand for their products, as evidenced by market characteristics like the small number of dominant agencies and issuer-based fee structures (Partnoy 1999, 651–654, 681–682; also see White 2002; Kerwer 2002).

The ontology of credit ratings

Given the degree to which investors, banks, other financial institutions, and their regulators – in fact, the entire global financial system – have come to rely on credit ratings to address information asymmetries in the

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marketplace, 'greasing the wheels of capitalism' by permitting investors to part with their money more comfortably, there is a surprising lack of awareness regarding what it is rating agencies actually do, and how they do it (Sinclair 1999, 161).

The sovereign credit rating process for each of the Big Two is built around the 'rating committee', typically comprised of managing directors and analysts of varying backgrounds and levels of expertise (Beers and Cavanaugh 2004; Hilderman 1999). Both Moody's and Standard & Poor's look to a number of economic and political criteria broadly indicative of 'willingness' and 'ability' to repay debt obligations, while emphasizing the centrality of 'qualitative' (i.e., subjective) judgment and the lack of any strict methodology (Beers and Cavanaugh 2004; Hilderman 1999, 1, 3; Pinkes 1997, 3; Truglia 1999, 61–62). The ratings themselves, assigned both to issuers and issues, are basically letter grades establishing a relative hierarchy of creditworthiness.[3] Typically a first-time rating, once determined by the committee, is communicated to the issuer, which may choose not to make it public, though there are significant exceptions to this general rule (e.g., issuances into the U.S. market) (Murray 1999, 3–4).

Standard & Poor's rating process is broadly representative. Once a sovereign seeking a rating has entered a formal agreement with Standard & Poor's and forwarded preliminary economic and financial data, a team of two or more analysts visits the country for three to four days to meet with finance ministry and central bank representatives (including top officials), as well as a range of constituencies outside the government thought to be knowledgeable on politics and economic policy. The analysts then prepare for the rating committee a report including a suggested rating and rationale, which the committee assesses through a number of quantitative and qualitative lenses representative of 'economic risk' (the sovereign's ability to repay) and 'political risk' (the sovereign's willingness to repay). There is 'no exact formula' through which such considerations factor into the eventual rating (see Abdelal and Bruner 2005b).

Actual committee discussion remains the 'invisible ingredient in the ratings process' across the agencies, though reportedly it 'often center[s] around intangible issues such as a government's propensity for 'orthodox' vs. 'heterodox' policy responses when under acute debt-service pressure'. It is thought that the 'heavy workload . . . may result in an element of piggybacking' on the work of other institutions, including 'the IMF, academia, investment banks, and – conceivably – other rating agencies', and 'key inputs' in the analysis of domestic politics include the likes of 'the Economist Intelligence Unit's *Country Reports* and *Country Profiles*, Transparency International's *Corruption Perceptions Index*,

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and Freedom House's list of 'true democracies' (Bhatia 2002, 15, 26–27, 45).

Given the highly subjective nature of credit rating – especially with sovereigns, for which politics and willingness to repay are of special concern (Beers and Cavanaugh 2004; Truglia, Levey, and Mahoney 1995, 4–5) – it follows that the process is permeated by ideologically conditioned judgments. Numerous observers, particularly those from outside the United States, have argued that despite their objective posture, the major agencies' credit ratings reflect a U.S.-centric, liberalist ideology (Murphy 2000; Kerwer 2002, 43; Sinclair 1994, 454–455; Subramanian 2002). For instance, while a sovereign rating will inevitably reflect the analyst's general perception of political stability and institutional transparency, Standard & Poor's looks more specifically at whether governmental 'separation of powers' and 'civil institutions, particularly an independent press', have developed such that 'policy errors' can be 'identified and corrected' quickly (Beers and Cavanaugh 2004). Standard & Poor's also favors 'a market economy with legally enforceable property rights' as 'less prone to policy error' (Beers and Cavanaugh 2004).

Of course rating agencies are far from unique in permitting their ideological and cultural preconceptions to permeate the transactions in which they engage (Sassen 2002, 99), and in any event, while undoubtedly reflective of a particular ideology, few (at least in the West) will query the general wisdom of encouraging the dispersal of political power, a free and vigorous press, meaningful property rights, and an efficient marketplace. More troubling is the implied litmus test – that countries that have gotten this right will be identifiable because they will not make 'policy errors'. Standard & Poor's description of the sorts of characteristics that are generally observed in countries at various rungs on the ratings ladder begins to illuminate what this might mean. Sovereigns in higher ratings categories tend to exhibit '[o]penness to trade and integration into the global financial system', with economic policies that, in general, are 'cautious, flexible, and market-oriented', indicating that 'orthodox market-oriented economic programs are generally well established'. Lower-rated sovereigns, on the other hand, place 'more restrictions' on trade and investment, and '[o]rthodox economic policies are usually not well established' (Cavanaugh 2003).

The concept of an 'orthodoxy' is certainly evocative, but little in the way of substance is provided beyond affirmation of the liberalist commitment to openness. In essence, 'orthodoxy', as used by Standard & Poor's in its methodological literature, appears simply to be a positive term describing the absence of 'policy errors' associated with a lack of openness. Standard & Poor's emphasis on policy in its ratings, and in other communications to sovereigns, provides some confirmation of this.

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Following the Asian financial crisis, Standard & Poor's made eminently clear to bruised emerging markets that their 'policy reactions . . ., more so than any new IMF-led support packages', would be 'key to their credit standing', just as the appropriateness of policies undertaken during the crisis had determined 'the rating actions that Standard & Poor's [had] taken in response to them' (Beers et al. 1998). Malaysia, for instance, did not default, though it pursued the 'less disruptive but still damaging' policy of imposing capital controls, contrary to the preference for openness (Beers et al. 1998; also see Abdelal and Alfaro 2002). The degree to which this actually constituted 'error' remains questionable, and in any event, Standard & Poor's has since backpedaled on the question of capital controls, as has Moody's (Beers and Cavanaugh 2004; Mahoney 1999, 57). The fact remains, however, that whether the judgment was right or wrong, Malaysia's cost of borrowing went up when their sovereign rating was downgraded.

It is not surprising that, in many cases, 'policy errors' can be very difficult to identify with any certainty, and that in such cases they are more or less in the eye of the beholder. Of course Standard & Poor's is not alone; Moody's later conceded that it had 'indulged' in a 'blame the borrower' response to the Asian financial crisis, and observed that 'if the true causes of the crisis have been misdiagnosed, then the prescriptions for remediation may be wrong as well' (Mahoney 1999, 54, 57; Byrne et al. 2000, 64). Predictably, where matters are highly 'qualitative' and 'subjective', as they are with sovereign credit ratings, what is deemed 'policy error' will turn largely on who gets to speak. This is not to suggest that credit ratings are themselves in error all or even much of the time, but rather that the essence of a credit rating lies not so much in what is said, but in who said it. Put differently, the significance of a rating in today's global economy derives not from the ideas or information conveyed so much as from the various social, financial, and legal institutions that favor dominant agencies' opinions by hinging various financial and regulatory consequences on their ratings.

That this is so is supported by a growing body of empirical evidence on determinants and relative timing of sovereign credit ratings. One notable study by Richard Cantor and Frank Packer argued, for instance, that Moody's and Standard & Poor's sovereign ratings 'can be explained by a small number of well-defined' economic variables, 'which the two agencies appear to weigh similarly' (Cantor and Packer 1996, 37, 45). This study also found evidence suggesting that '[a]gency announcements of a change in sovereign risk assessments appear to be preceded by a similar change in the market's assessment of sovereign risk', but that '[c]ontrary to our expectations, . . . market anticipation does not reduce significantly, if at all, the impact of a sovereign rating announcement'

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(Cantor and Packer 1996, 45, 48). Put differently, the agencies often simply tell the market what it already knows, and yet their 'announcements' continue to have impact. The authors of this study conclude that 'sovereign ratings effectively summarize and supplement the information contained in macroeconomic indicators', though it is unclear what this 'supplement' might consist of beyond the major agencies' confirmation (at best) or regurgitation (at worst) of established market perception (Cantor and Packer 1996, 49).

This pattern is most troubling in the days preceding and following a major financial crisis. Joseph Stiglitz, for instance, has argued that 'excessive liberalization is systematically related to a higher probability of crisis', and that 'ideology, rather than science' has dictated economic development strategies over recent decades (Stiglitz 1999, 253; also see Stiglitz 2000, 1075; Stiglitz 2002, xiv). Stiglitz and colleagues G. Ferri and L.G. Liu have also argued that before and after the Asian financial crisis the 'rating agencies attached higher weights to their qualitative judgment than they gave to the economic fundamentals' (Ferri, Liu and Stiglitz 1999, 349). More specifically, they argued that Indonesia, South Korea, Malaysia and Thailand received ratings before the crisis that were 'consistently higher than the economic fundamentals would warrant', and ratings following the crisis that 'dropped much more sharply' than such fundamentals required. Stiglitz and his colleagues speculated that the agencies had downgraded these sovereigns all the more harshly after the crisis in an effort to 'protect their reputation capital', having largely failed to see the crisis coming (Ferri, Liu and Stiglitz 1999, 347, 349, 352–353). Such results, taken together with the empirical data on economic determinants of sovereign ratings, sketch an interesting composite picture. In general, these studies suggest, sovereign ratings summarize basic economic data that the market already possesses. At extreme high and low points of the economic cycle, however, such as the emerging-market euphoria of the mid-1990s and the crash that followed, the agencies' 'qualitative' judgment takes over as they follow the market upward, and then scramble to react when the bottom falls out. Moody's, in particular, has strenuously objected to these charges (Amin-Salem et al. 1998, 7).

Increasing scrutiny

In most markets none of this would constitute a particularly damaging indictment. Predicting the future is difficult in the extreme, and firms make mistakes. Usually, when firms make very large mistakes, market discipline is unforgiving. Clearly, however, the market for ratings is different. Ratings are incorporated into regulation; right or wrong, they

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cannot be ignored by regulated investors. This reality has been brought home to regulators in the United States not, however, by emerging market crises, but by Enron and other spectacular corporate bankruptcies of the new millennium (Sinclair 2003, 155–156; Subramanian 2002). In the wake of such scandals, Congress predictably held hearings on the agencies' role (noting Enron's investment grade status just days before its bankruptcy was announced), and through the Sarbanes-Oxley Act of 2002 instructed the SEC to review the industry. The SEC, which had, in vain, proposed in 1997 that a more structured NRSRO designation process be implemented, requested comments from the public regarding 'the appropriate degree of regulatory oversight that should be applied to credit rating agencies' and whether the NRSRO concept should be modified or eliminated altogether – a move that could entail a wholesale rethinking of the regulation of credit risk (SEC 1997; SEC 2003b). Some, for instance, have argued that something more market-based and objective (e.g., credit spreads) be used to eliminate the problems created by the use of credit ratings (Partnoy 1999, 704), though concerns remain regarding the volatility of market-based measures (Mahoney 2002).

The Big Two actually fell on opposite sides of the NRSRO question, with Standard & Poor's in favor of keeping the concept and Moody's urging that it be eliminated (O'Neill 2003; Corbet 2005; McDaniel 2003; McDaniel 2005). Setting aside the merits of the question, one might have thought that the interests of the Big Two would be identical, given their dominance and widespread demand for two ratings. Moody's has, in fact, quite candidly observed that 'as private, profit-oriented entities', agencies 'will not ignore invitations and inducements to enter markets', but that where, as in the United States, 'growth in demand for ratings is not only due to natural market forces, but due to artificial demand for ratings and rating agencies mandated by regulation', ratings no longer function as opinions to be taken or left by investors, and market discipline is accordingly sacrificed (Pinkes 1997, 1, 3, 5). Standard & Poor's, on the other hand, has taken the view that 'the wholesale withdrawal of the NRSRO concept could be costly to market participants which are subject to such regulations and disruptive to the market' (O'Neill 2003; also see Corbet 2005). The Big Two clearly face a difficult cost-benefit problem. Standard & Poor's position is consistent with recognition of the decrease in revenues that might well result from elimination of the NRSRO concept, while Moody's position is consistent with recognition of the potential for increased scrutiny of the ratings industry – and even direct regulation – already clearly on the minds of Congress and the SEC.

Indeed in February 2005 the U.S. Senate Committee on Banking, Housing, and Urban Affairs (the Senate Banking Committee) convened a hearing on the agencies, noting that they 'wield extraordinary power in

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the marketplace', acknowledging the view that the NRSRO concept 'has evolved into a quasi-official stamp of market credibility that acts as a barrier to entry', and expressly seeking to 'address the potential for conflicts in this industry' (Shelby 2005). The SEC has also revived its attempt to clarify the 'NRSRO' concept, introduce procedural transparency and reduce barriers to entry, voting at its March 3, 2005 open meeting to move forward with a new rule proposal that would (among other things) explicitly permit sector-specific NRSRO designation, while retaining the circular market acceptance requirement (Donaldson 2005a; Nazareth 2005).

Numerous references were made in both of these settings to conflicts of interest (see Shelby 2005; Stabenow 2005; Egan 2005; Goldschmid 2005), perhaps reflecting a rational likening of credit rating to financial auditing, an activity similarly rife with potential conflicts (and in which private-sector judgments, incidentally, are similarly ensconced in regulation). At the same time, this preoccupation may reflect the regulator's pragmatic focus on an issue more easily identified, described, and resolved than are the more fundamental problems arising from regulatory incorporation of credit ratings. Many – even the pro-market *Economist* – have advocated additional regulation of the agencies (*Economist* 2005a). As observed by one SEC Commissioner desirous of greater 'diligence' in the agencies' work, however, even if Congress were to grant the SEC broad oversight authority with respect to the agencies, such a regime would likely be 'compromised' by protections afforded the agencies under the First Amendment to the U.S. Constitution (i.e. as nominal journalists), which might 'place the SEC in the same situation that it is in today' (Atkins 2005).[4] Conflicts of interest, on the other hand – regardless of the efficacy of the agencies' internal policies and procedures to address them, and regardless of the public good rationale for issuer fees – present regulators unable to contemplate abandoning ratings-dependent regulation, and yet unable effectively to regulate the agencies themselves, with an easily grasped alternative problem that is already on the public's mind (see Morgenson 2005; *Economist* 2005a; *Economist* 2005b), and for which a set of recently minted responses (post-Enron) already exists.

The situation elsewhere is complicated by the agencies' perceived lack of cultural awareness. In Asia, the major rating agencies have met fierce resistance, due in large part to a perceived lack of understanding of 'Asian business practices' (Sinclair 2001, 443). The agencies have encountered similar problems with sovereigns, as in Japan where sovereign downgrades have been 'dismissed' as 'nothing but interference' and 'unnecessary meddling' (Sinclair 2003, 154, quoting Financial Services Minister Hakuo Yangisawa) driven by application of the U.S.-based agencies' 'home standards' (Sinclair 2003, 154, quoting

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Kurosawa Yoshitaka of Nihon University). Given such views, the move to develop domestic agencies is unsurprising (as is their tendency to rate Asian companies higher than do their foreign counterparts), though their global expansion has been limited, at least in part, by their inability to achieve NRSRO status (Japan Center for International Finance 2001; Harada 2005). In China, meanwhile, regulators have sought to foster industry standards as a means of combating high levels of corruption in the credit ratings business (some '80 pct of credit rating agencies' businesses' reportedly being 'connected to companies seeking banking loans') (XFN News 2004; also see AFX Asia 2005).

European critics have likewise argued that 'Europe doesn't have a major rating agency that would take into account the special characteristics of European accounting or the prevailing differences in financial ratios as they evolved in a bank-based financial system', and sovereigns not amenable to foreign criticism have found themselves in the agencies' cross hairs on important issues of domestic policy (Engelen 2004; Kraemer and Marchand 2002; Sinclair 2003, 151–155). European parliamentarians have increasingly complained about industry concentration, the U.S.-centric orientation of the major agencies, the 'protectionist overtones' of the NRSRO system, and the fact that 'European capital markets are faced with the prospect of an ever-increasing use of rating assessments for business and for regulatory purposes' (European Parliament Committee on Economic and Monetary Affairs 2004, 5–6). A European Parliament report (not adopted by the full Parliament, no doubt to the agencies' relief) blasted the agencies, arguing that 'the predominantly American character of the agencies and of their supervisors (i.e., the SEC and Congress) creates a vast de facto imbalance toward the American side', that Europe needs a regulatory body to oversee the agencies, and that 'the effective duopoly of the two main agencies has to be confronted by means of a possible break-up . . . along lines of specialisation' (European Parliament Committee on Economic and Monetary Affairs 2004, 9–11; also see *The Banker* 2004). While not yet ready to go this far, the European Parliament has directed the European Commission to report back by July 2005 with its views on regulation of the agencies (European Parliament resolution on Role and Methods of Rating Agencies [2003/2081(INI)]). The Commission, in turn, looked to the Committee of European Securities Regulators (CESR) for advice, in response to which the CESR endorsed the voluntary code of conduct published by the International Organisation of Securities Commissions in December 2004. CESR members largely favored a 'wait and see' approach, but concluded that '[s]hould self regulation fail to deliver, there might be a need for statutory regulation' (CESR 2005). In any event, the message is clear. In the words of a German finance official,

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Jochen Sanio, the agencies are 'uncontrolled world powers that are directing global capital flows' (quoted in Engelen 2004) – a state of affairs that Europe is unwilling to live with in the long run.

Notwithstanding all of these criticisms, however, a number of national governments are perpetuating a striking contradiction. At the same time that legislative and regulatory bodies in the United States and the European Union question the appropriateness of incorporating rating agency opinions into regulation, their own central bankers and finance ministers are embarking on a massive expansion of ratings-dependent regulation in the form of Basel II's 'standardised approach' to bank capital adequacy. The lack of clarity on alternative structures, and the simultaneous criticism of and increasing reliance upon credit ratings, reflect the degree to which governments and investors have grown dependent on these private-sector entities, whose work and role in global capital markets remain, at best, dimly understood.

The ratings business, meanwhile, is as profitable as ever, and presumably can only benefit from the new terrain that Basel II opens to it. Standard & Poor's was a 'key growth driver' in 2003 for McGraw-Hill (the publishing company of which it is a division), bringing in revenue of approximately U.S.$1.8 billion (over 36% of McGraw-Hill's revenue) and approximately U.S.$667.6 million in profit (over 60% of McGraw-Hill's profit) (McGraw Hill Companies 2003, 27, 32, 42–43). Moody's also did well in 2003, reporting approximately U.S.$1.1 billion in revenue (over 90% of consolidated revenue of Moody's Corporation, the rating agency's parent), and approximately U.S.$657.1 million in operating income (over 99% of consolidated operating income) (Moody's Corporation 2003, 19–20, 69–70). Though the Big Two are 'reluctant to discuss specific fees charged for ratings', their fees have been estimated to range from U.S.$25,000 up to U.S.$125,000 (or approximately 3–5 basis points on the issue).[5]

Opinions, standards, and rules

It is widely recognized that Standard & Poor's and Moody's today wield remarkable power, as 'gatekeepers' to capital markets, over sovereign and private issuers alike (Kerwer 2002; Sinclair 1999, 161). And yet ironically, this is incompatible with the agencies' own views regarding how ratings should be used in arriving at investment decisions. The agencies continually emphasize that a rating is just an 'opinion', that it is a relative rather than absolute measure of credit risk, and that as such, a rating is only one of many variables that an investor should consider before arriving at a decision to buy, sell or hold a debt security. In Moody's view, 'informed investors who come to their own conclusions

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about credit quality make more effective use of ratings in managing financial risk', and 'the probability of default is only one factor that investors legitimately consider in making their decisions to lend' (Turner 1999, 6). This view makes sense enough in the abstract. However, real-world institutional investors whose hands are forced by rating changes across the all-important 'investment grade' line, and sovereigns whose policymaking discretion is greatly curtailed by the need to please foreign, largely unregulated private-sector entities, know better (SEC 2003a; Sinclair 1994; King and Sinclair 2003; European Parliament Committee on Economic and Monetary Affairs 2004; Subramanian 2002).

The difference between the ideal and the reality is the functional difference between 'standards' and 'rules'. The agencies present their ratings as 'opinions' that investors can take or leave. When the SEC in 2003 requested comments on the need to regulate rating agencies, Standard & Poor's emphasized that generating a rating involves 'the forming of opinions about that issuer or security and the broad dissemination of those opinions to the public', activities 'highly akin to those regularly performed by professional journalists' (which characterization opens a strong First Amendment defense against intrusive regulation and civil liability) (O'Neill 2003). Likewise Moody's stressed that 'ratings are predictive opinion forecasts about an uncertain future, not statements of fact' (and on this basis has opposed 'any supervision processes that would impair existing Constitutional, federal or state law protections designed to mitigate our exposure' to subpoenas and litigation) (McDaniel 2003).

Few would contest that ratings originally performed as the agencies describe. Ideally, ratings serve as 'signposts' for investors in vast and complex markets, constituting a simplified vocabulary and conceptual framework through which to talk about credit risk (Kerwer 2002, 43). This is the sense in which rating agencies have been described as 'standard setters'; their ratings opinions, in the aggregate, create a nonbinding 'common understanding of what constitutes creditworthiness', and in this respect represent 'advice given to many' deriving force from 'the legitimacy of the underlying expertise' (Kerwer 2002, 45). The agencies 'vet and judge practices', thereby 'narrow[ing] the expectations of creditors and debtors to a certain well-understood or transparent set that is shared among themselves' (Sinclair 1999, 161; King and Sinclair 2003, 357–358). The check on the agencies' power, in this ideal scenario, is the need to preserve their reputations. That is, they are permitted to play this standard setting role only to the degree that they have earned investors' trust through performance of their ratings over time as predictors of default.

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This balance is thrown off, however, when the 'standards' become 'rules', as when legislative and regulatory bodies incorporate them into regulations, imbuing them with the force of law. Regulatory use of ratings compromises the exertion of market discipline upon rating agencies both directly and indirectly. First, market discipline is reduced directly through the creation of artificial demand for the ratings of designated agencies as investors seek to satisfy regulatory requirements. (While the empirical evidence on this point is mixed [Steiner and Heinke 2001, 139; Cantor and Packer 1997, 1409], Moody's itself acknowledges this to be the case [Pinkes 1997, 1].) When regulatory compliance hinges on credit ratings, regulated investors have no option but to follow them (Kerwer 2002, 45; Partnoy 1999, 684). Second, market discipline is reduced indirectly to the extent that agency designation requirements for ratings-dependent regulation constitute a barrier to entry into the ratings market, insulating incumbents from potential competitors (Kerwer 2002, 45; Partnoy 1999, 710). Both Moody's and Standard & Poor's have in fact expressed support for a more transparent NRSRO designation process, though this may simply reflect confidence that their near total market dominance is effectively unassailable, and/or recognition that in light of the danger of substantive regulation of agencies, the added competition of a few more NRSROs is the least of their worries (O'Neill 2003; McDaniel 2003).

Private actors and public power

This dynamic of private-sector actors wielding *de facto* government power is neither new nor unique. An extensive body of scholarship has examined, for instance, the various roles that 'networks of knowledge-based experts', sometimes called 'epistemic communities', have played in policymaking, particularly with respect to conditioning 'the manner in which problems are understood by the policymakers or are represented by those to whom they turn for advice under conditions of uncertainty' (Haas 1992, 2–3). The 'epistemic' concept has been employed to explain 'the authority exercised by [rating] agencies and its relationship to knowledge', the point being, as Timothy Sinclair (1999) puts it, that 'they do not seek to persuade, but to make judgments'. While in theory this 'epistemic authority' to judge rests on market perception, and thus could be lost if the market turned on them, such authority 'is, by its very nature, hard to budge, as others are likely to discount the 'mistakes' or epistemic failures of the agencies, given their stock of eminence' (Sinclair 1999, 159).

A key difference, however, between the 'epistemic community' as traditionally conceptualized, and credit rating agencies, is that the epistemic community tends more to inform and influence policy decisions

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that ultimately are taken by government officials, whereas rating agencies have effectively been deputized to make decisions themselves that have direct policy consequences. Perhaps a more apt theoretical approach would be that of so-called 'coordination service firms' – that is, 'firms that operate to coordinate the behaviour of other firms', of which additional examples would include 'multinational law, accounting, management, and insurance firms, stock exchanges . . . and financial clearinghouses' (Cutler 2002, 28; also see Sinclair 1999, 153, 161). However, this concept similarly fails to illuminate the dynamics of regulatory infusion of public power into erstwhile private-sector judgments (even though this phenomenon may manifest itself through a number of types of coordination service firms). Crucially, when a rating agency downgrades a security to speculative grade, the agency has effectively commanded certain regulated investors to sell. And when an agency revises its methodology to judge and characterize credit risk in a new way, this decision is essentially given automatic effect through pre-existing regulatory recognition.

While rating agencies may have initially gained prominence as purveyors of expert knowledge, the current degree of authority they exercise over the flow of global capital reflects, to some degree, the changing regulatory role of domestic governments in an age of financial globalization. The rating agencies' relationship with sovereigns is not best understood in terms of relative power – which they have gained and lost. Rather, this aspect of what Ruggie calls the 'global public domain' is wholly new. Governments – particularly the U.S. government, but also the G10 representatives meeting in Basel – have deputized the rating agencies. Public authority has not been privatized. Indeed, it is just the reverse: Private authority that emerged spontaneously, and which previously had no public counterpart, has been given public standing through laws and codes.

That powerful sovereigns like the United States have not exercised direct authority in the market is therefore not an accommodation of the inevitable. These were decisions, often made with a purpose. It undoubtedly remains true that 'governments routinely obfuscate their final authority in financial markets' in an 'intentional effort to render opaque political responsibility' for difficult decisions (Pauly 2002, 77). There are at least two ways in which declining to undertake direct market regulation through the use of ratings-dependent rules benefits U.S. policymakers. First, increased latitude for private-sector actors to pursue international transactions freely has meant the dissemination of U.S.-centric standards globally. New York-based Moody's and Standard & Poor's are, ironically, in a position to tell other governments what to do and how to conduct their economic policies in a blunt vocabulary

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unavailable to the U.S. government. These private-sector injunctions are lent far greater force when incorporated into regulations, forcing U.S. institutional investors to act upon the agencies' assessments of the policies pursued by other sovereigns, withdrawing funds (and raising the cost of borrowing) when those policies are frowned upon. Second, the use of credit ratings in financial and other regulations permits policymakers to distance themselves from domestic political fallout when the regulation of credit risk goes awry. When Enron collapsed with no warning from the rating agencies, capping a series of perceived failures including several global financial crises in the 1990s, Congress and the SEC could call hearings, investigate, and berate the agencies, querying whether ratings-dependent regulation makes sense in the future, without digging too deeply into whether incorporating them in the past was simply a bad decision in the first place (SEC 2003a).

This disjuncture between authority and responsibility creates what Dieter Kerwer (2002, 43) has called an 'accountability gap'. Ratings opinions are characterized by the agencies as standards, which the user can take or leave. The user is responsible, however, 'since per definition the adoption of a standard is voluntary' (Kerwer 2002, 45). When a standard is given the force of law through government enforcement, however, the standard setter arguably should be treated as a rule setter, with full accountability for what has effectively become a rule. When this does not happen, 'the standard setter acquires power by third-party enforcement, which is not checked by corresponding accountability' – hence the gap (Kerwer 2002, 46). It should also be observed, however, that deputizing a standard setter in this way creates a corresponding 'accountability gap' in government as well. Policymakers get to make rules, but dodge responsibility for them, by piggy-backing on the decisions of others, whom they can blame when things go wrong. Congress and the SEC cannot be held accountable because they are not the author of the rule content, only the rule framework; they relied on the 'experts' to get the substance right (Kerwer 2002, 45–46). Likewise, the rating agencies cannot be held accountable because while they may have authored the content, they never asked to have a rule framework built around it; they are purveyors of 'opinion', self-proclaimed journalists with a ready made First Amendment defense against civil liability and regulatory intrusion into their operations.

Dealing with uncertainty

To be sure, regulating something as abstract as credit risk exposure is far from straightforward. Whereas policymakers encounter forms of uncertainty in the process of arriving at all kinds of concrete policy initiatives,

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in the case of credit risk, uncertainty is the very object of policy itself. Obviously investment, and regulation thereof, are inherently forward looking, and therefore uncertain. While investment is greatly facilitated by the reduction of uncertainty, however, it cannot be eliminated; Moody's itself has stressed that for 'ratings and credit analysis to be effective indicators of risk, markets must operate so that investors really are at risk of loss, and know it' (Turner 1999, 1). This is not really the fundamental problem, however, because even if investors understand that there is an inherent remainder of uncertainty in any measure of credit risk (which must be true, or it would not be risk), they generally still assume that the basis for credit ratings is fundamentally sound and meaningful. This capacity to view a complex world through a simple set of comparative symbols is the rating agency's stock in trade – it is what a rating agency sells to investors (or at least used to, in the days of subscription-based fees). It is crucial to observe that the apparent reduction of complexity through credit ratings both conveys information and elides it. Whatever information a credit rating may convey to the market, it also undoubtedly permits semi-willful ignorance of the full measure of uncertainty inherent in investment. To the extent that credit ratings' 'very existence increases the investors' risk appetite' – based at least in part on faith in the process of their production – the agencies are 'absorbing uncertainty for investors, making unpleasant surprises about credit risk more likely' (Kerwer 2002, 43). For agencies to criticize investors for 'accept[ing] the rating symbol as an absolute value and apply[ing] it as an investment criteria without questioning the rationale' (Turner 1999, 4) is perhaps hypocritical when – setting aside the wisdom of doing so – the very selling point of the letter-grade system is the economy of thought it invites.

The simplicity of the letter-grade system is likewise undoubtedly the root of its attractiveness as a regulatory tool, as evidenced by extensive use in the United States through the NRSRO concept, and its recent incorporation into worldwide prudential regulation of banks through the Basel II framework. Couple this with the dual-incentive for U.S. policymakers to dodge political accountability for the regulation of credit risk, while augmenting the capacity of private-sector institutions to enforce U.S.-centric governance norms abroad, and the pull of credit ratings as a regulatory tool is all but inescapable.

Thus, the government and the agencies appear to have come to a tacit understanding, which is increasingly under threat. Rating agencies get rule-like enforcement of their nominal standards, the accompanying market demand for their product, insulation from methodological scrutiny (through the absence of direct regulation), and a shield from civil liability (through the absence of any serious challenge to their status as

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nominal First Amendment 'journalists'). In exchange, the agencies offer themselves as a repository for residual uncertainty associated with credit risk (that might otherwise temper investor confidence and expose policymakers to the discipline of democratic accountability), accept (limited) reputational liability when things go wrong, and enforce an implicit U.S.-centric, neo-liberal ideology around the world (upon private and sovereign issuers alike) as gatekeepers to the U.S. investing public. This unspoken *quid pro quo* depends on the dissociation of power and accountability, and the dissociation of reputation and market demand. Both result in large part from the incorporation of credit ratings into regulation.

Conclusions: Opening up the ratings

We have identified at least three serious drawbacks of the current relationship between public and private authority in the bond markets. First, sovereign governments, particularly in emerging markets, have seen their policy making discretion curtailed as affluent countries' regulators decline to undertake direct financial and prudential regulation, effectively augmenting the authority of unaccountable firms to define – or at least reproduce – the terms of orthodox economic policy making. Second, non-sovereign issuers of debt effectively must, like sovereigns, seek out ratings from an artificially narrowed set of dominant agencies in order to tap international capital flows. Third, regulated investors, and the fund managers acting on their behalf, are being forced by the codification of the rating agencies' role in the markets to adjust their portfolios based on judgments that imply a much greater reduction in uncertainty than can really be the case.

These are consequences that flow quite directly from the enforcement of simplistic letter-grade credit ratings through financial and prudential regulatory rules. As an increasing body of critics – private and public sector alike – are recognizing, the costs of such a regulatory approach may well be exceeding the benefits. There are good reasons to think very seriously about reconnecting power with accountability, and reputation with actual market demand.

The most obvious remedies would be either to replace credit ratings in regulation with a more market-based measure, or to keep the credit ratings but regulate the agencies. Both have their advocates and their detractors. Removal of ratings would force regulators to arrive at some alternative measure of credit risk through the typical rule-making process. Presumably the views of various 'expert' communities would be solicited and considered in an open and democratic manner, with a final

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determination of a more market-based measure settled upon by government itself. The Big Two would be freed from the specter of government regulation of their operations, but also denied the benefit of government-enforced demand for their products. The empirical literature on credit ratings presents a range of options worthy of consideration.[6] Were the agencies themselves to be regulated, the methodological 'black box' – only dimly understood notwithstanding the major agencies' publications on ratings criteria – would be opened up, its contents scrutinized, the true nature and extent of uncertainty reduction made more clear, and its ideological biases opened for discussion.

To the extent that either or both of these options prove politically or (in the case of agency regulation) legally impossible, a better, simpler, and more realistic near-term solution might be simply to mandate bifurcation of the so-called 'quantitative' and 'qualitative' aspects of NRSRO credit ratings, while retaining both. In addition to credit ratings as currently issued by the agencies, reflecting the full range of quantitative and qualitative considerations, an additional quantitative-only rating could be issued. While it is undoubtedly true that 'qualitative and judgmental aspects of analysis are unavoidable even in the interpretation of quantitative indicators' (Levey 2002, 89), empirical research demonstrating the predictive capacity and, in some circumstances, the superiority, of defined economic 'fundamentals' (Cantor and Packer 1996; Ferri, Liu and Stiglitz 1999) suggests that a practical bifurcation could be undertaken.

The normative and practical advantages of such an approach over the *status quo* are substantial. The full benefit of the analyst's expertise would be retained, while the black box would be opened at least enough to allow users of ratings to discern what a given agency's conception of the quantitative fundamentals actually is, and how much a given overall rating is affected by the analyst's unavoidably ideological, qualitative analysis of factors like 'political risk' – achievable through simple subtraction, even in the absence of any coherent statement of principles guiding qualitative analysis. This approach sacrifices nothing, as the presently conceived overall rating would be retained, but more information would be provided in the form of greater nuance, in much the same way that it was when numerical modifiers were introduced to differentiate relative credit risk within a letter-grade category (Kliger and Sarig 2000, 2879). Investors would get a more objective picture of an issuer or an issue, plus the overall picture as refracted through the analyst's perceptions, helping to combat the complacent assumption that uncertainty has been reduced more than it really has, and providing additional information from which to determine absolute – as opposed to relative – credit risk. Sovereigns subject to the agencies'

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policy prescriptions would be armed with additional information through which to assess their own economic circumstances, and a more nuanced sense of the agencies' ideological perspectives. Such an approach would also facilitate regulatory consideration of alternatives to ratings-dependent regulation through increased disclosure of the agencies' methodological thinking – and avoid the more obvious political and legal complications associated with regulating the actual substance of agency analysis.[7]

Even the staunchest critics of the rating agencies tend to recognize that identifying the flaws in the present system is far easier than working out solutions. Though the long-term benefits of reducing or eliminating regulatory dependence on credit ratings would be substantial, there is of course a danger of throwing out the baby with the bath water; hasty action could result in settling upon a market-based measure of credit risk that fails to out-perform credit ratings, thereby damaging already fragile investor confidence. A primary virtue of the bifurcated ratings model advocated here is that it is information-augmenting.

At present, movement on these issues remains tentative at best because the stakes are high and the answers are far from obvious. It is time to consider a more gradual approach to reducing regulatory dependence on credit ratings, a goal that might best be achieved by opening up the ratings themselves.

NOTES

1. For insightful comments on previous drafts of this paper, we thank Jonathan Kirshner, Debora Spar, Richard Vietor, Louis Wells, David Yoffie, and two anonymous reviewers. We are grateful to Harvard Business School's Division of Research and Faculty Development for supporting this project.
2. Thomas Hobbes, *Leviathan*, edited by Edwin Curley (Indianapolis: Hackett Publishing Company, Inc., 1994) (with variants from the Latin edition of 1668), Pt. II, Chap. xviii, 9, p. 113.
3. Standard & Poor's long-term issuer ratings, for example, include AAA ('extremely strong' capacity to repay); AA ('very strong'); A ('strong'); BBB ('adequate'); BB ('less vulnerable'); B ('more vulnerable'); CCC ('currently vulnerable'); CC ('currently highly-vulnerable'); R ('under regulatory supervision'); SD ('selective default'); D ('default'); and NR ('not rated'). Ratings of BB and below are considered non-investment grade, or 'speculative' grade (S&P 2002).
4. Several SEC Commissioners expressed desire for greater regulatory oversight of credit rating agencies, bemoaning the current lack of statutory authority (Goldschmid 2005; Atkins 2005; Glassman 2005), and Chairman Donaldson later told the Senate Banking Committee that if Congress wanted more than the voluntary framework sought by the NRSROs, it would have to provide such oversight authority (Donaldson 2005b).
5. Standard & Poor's fees have been estimated at U.S.$25,000 to U.S.$125,000, 'with the usual fee amount being 0.0325% of the face amount of the issue' for corporate debt issues, while 'Moody's typical charges were understood in 2000 to be approximately 3–5 basis points . . . on the issue amount, with a minimum of $25,000 and a maximum of $80,000 (except for complex issues where the charges could run considerably more)', and with 'some discounts . . . available for large, multiple issuers' (Smith and Walter 2002, 302).
6. See, for example, Partnoy (1999, 704) on the use of spreads; Cantor and Packer (1996) on identifying certain economic variables closely associated with sovereign credit ratings; and Ferri, Liu and Stiglitz (1999) on the possibility of measuring the performance of sovereign credit ratings before and after the Asian financial crisis against a specified set of 'economic fundamentals'.

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7. This is not to suggest that the agencies would not seek to characterize this proposal as an impermissible intrusion on their activities. However, the agencies may come to see this proposal as the least unattractive among the variety of regulatory activities currently being discussed.

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Editing a Journal; a mini-symposium

Editing a journal isn't as easy as it looks. Encouraging people to write articles about interesting topics, and then assessing what they have written requires a variety of skills. Moreover, journals differ in the specific problems they present to editors.

A panel of journal editors at the American Political Science Association convention in New Orleans in September, 1985, gave ample evidence of the travails of editors – and of the stimulating yet different challenge that each faces. These are illustrated in the three short pieces that follow by Charles Jones, a political scientist with experience of editing an 'official' as well as a specialized journal; Chester Newland, a public administration expert editing a journal that consciously spans practitioners and academics; and the editor of the JPP.

The articles are reprinted from PS, a quarterly for members of the American Political Science Association, volume 19, number 1 (1986).

On Being an Editor Twice

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A panel at the recent APSA Meeting in New Orleans brought together a number of editors who were new to their present editing jobs. I attended as the Congress editor of the *Legislative Studies Quarterly*. Earlier, from 1977 to 1981, I served as managing editor of another journal – *The American Political Science Review*. Naturally comparisons between the two jobs were invited at the panel, and I have been asked here to comment on editing two very different journals.

Before taking the job, I had puzzled why the title was that of '*managing* editor of the *APSR*'. It did not take long to find out. It truly is a sizeable management responsibility. Speaking for myself, I simply was incapable of *editing* the journal. The discipline it serves is too diverse in terms of subject matter and research methods. It was essential, therefore, that I create processes by which editorial decisions could be made. Being editor of the Association's official journal is a humbling experience. But humility won't get the pages printed. One needs a reliable network of advisers, a system for recovering from the inevitable mistakes, an efficient and effective internal structure for moving paper, and enough

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protection to allow the work to proceed. Of course, it also helps to have skilled staff assistants. I had the best. In fact, the APSA still owes Mrs. Kendall Stanley, the editorial assistant during my tenure, more than it can possibly repay.

One thing an *APSR* editor soon learns is that lots of people have opinions about the journal and its management. And, of course, they have every right to those opinions, as well as to the expectations upon which they are based. The journal belongs to the membership, directly as a function of payment of dues, indirectly through the governing body of the Association. The editor is directly answerable to the Council. My goal with regard to this official relationship was simple: keep the *APSR* off the top of the agenda. It was my good fortune to realize considerable success in that regard – particularly after the first few meetings.

The authors, manuscript reviewers, and readers constitute highly diverse groups for the editor to relate and serve. Many editors have commented on the problems and rewards in working with these groups. Suffice to say that the overwhelming majority in each set is reasonable if treated fairly. But you can understand, I trust, that fair treatment is itself a management problem of some proportion when you are dealing with many hundreds of professional scholars.

The problem of balance among the sub-disciplines is a worry of all *APSR* editors – truly it is. Unfortunately, it is not altogether clear what can be done to assure balance. It is difficult, if not impossible, for the editor to create research or to convince those doing it to submit their work to the *APSR* if they are satisfied with other outlets. One may even encounter a charge of pretentiousness in such an effort – if not from authors, then from editors of other distinguished journals.

Now, then, what about editing the *LSQ*? I know that some of you have traveled abroad on speaking tours for the United States Information Agency. Let's say it is February and you are in a cold hotel in an eastern European 'democracy.' Tomorrow you will speak to a few journalists and political scientists at a lunch on a subject chosen for you – a subject you know little about. There will be consecutive translation and so your 33rpm talk will have to be delivered at 16rpm. And you say say to yourself: 'God, what am I doing here? Why can't I go home?' Well, *LSQ* is going home for someone who has been out in the cold. It is just such a pleasure to work on a specialty journal in your chosen field of research.

What are the pleasures? First is the time that one has to work with individual manuscripts. Given the fewer number of manuscripts received, it is easier to be an editor, sometimes even suggesting changes that lead to improvements. Second, one can actually have an idea about what ought to be published and encourage that work to be done. It is simply easier to take an initiative with a journal like *LSQ*. Third is the pleasure of looking for papers at the conventions. Most specialty journals have the flexibility of being able to fit a manuscript into the publishing schedule. Fourth, *LSQ* can, and should, encourage young scholars to fashion articles from seminar work or theses and dissertations. A review of the table of contents over the ten-year history of this journal will show that it has performed this role admirably. Fifth are the rewards of working with two such dedicated professionals as Gerhard Loewenberg and Malcolm Jewell. Along with Samuel C. Patterson, they created and nurtured this fine journal. I am the beneficiary of their efforts.

At least in American politics, it is normally not possible for the specialty journal to compete with the prestigious general journals. Thus, for example, the *APSR* will continue to publish most of the best work on Congress. But we can offer

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an outlet for the excellent work that is not suitable for the general journal. Further, we can provide highly professional evaluations and normally we are in a position to put the work into print rather quickly. *LSQ* also thinks of itself as representing the field of legislative studies and thus, through the fine services of Michael Mezey, an effort is made to survey the ongoing literature in the field.

In an accompanying essay, Richard Rose explains the complexities of editing an international interdisciplinary journal of public policy. I am overjoyed that he has accepted the challenge of managing such a diverse intellectual enterprise. My present duties are less demanding – because of the journal's limited scope, to be sure, but also due to the effort and skill of my co-editors. The goal of *LSQ* remains what it has been from the start – to publish significant research on legislatures. We want the *LSQ* to be 'the' journal among legislative scholars – one that they must read to do their work as teachers and scholars; one that they will encourage their students to read, perhaps even subscribe to.

PAR: A Professional Journal for Practitioners and Academicians

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The *Public Administration Review* (*PAR*) is the principal journal for practitioners and academicians in the field of public administration (P.A.). From its inception in 1940, *PAR*'s mission has been 'to advance the science, processes, and art of public administration' by linking practice and scholarship. That is also the fundamental purpose of the *Review*'s sponsoring organization, the American Society for Public Administration (ASPA), which was formed less than a year before *PAR* was first issued. At its inception, ASPA's leadership was more heavily practitioner than academic, and the founders deliberately acted to make it an organization oriented to the *practice* of P. A. William Mosher, the first national president, was an academician, but his next four successors were foremost practitioners. In 1986, that initial orientation to practice still characterizes ASPA; over 80 percent of the Society's members are practitioners.

That fact helps provide definition of *PAR*'s purpose. It does not wholly define it, however. The *Review* was intended by its founders to serve not only as the principal mark of ASPA's professionalism but as a vehicle to advance the quality of practice, research, and teaching of P.A. The *Review* was intended to reach and speak to practitioners, but it was designed also to sustain and rely on scholarship. Its development and out-reach reflect that search for balance.

From its inception, *PAR* editorial processes have been principally the responsibility of an editor-in-chief, assisted by other editors and an editorial board which serves primarily to referee manuscripts. The first editor, Leonard White, was primarily an academician with practical experience; the second, Gordon R. Clapp, was a prominent practitioner. Their 12 successors have been primarily academicians, but some have had notable governmental service. The initial term of appointment by the ASPA president is three years, subject to extension. Two have served longer: Dwight Waldo, 1966–77, and Louis C. Gawthrop, 1977–84.

All articles published in the *Review* are selected through a refereed process, with blind reviews, generally three to six in total, for each manuscript received. Editorial board members do much of the referee work, but other authorities are also relied upon.

Referees are asked to return their evaluations within one month. Publication decisions are made by the editor-in-chief, working with an associate editor and the manuscripts editor. Most rejections are decided within six weeks of receipt by *PAR*. Other decisions rarely require over two months. Publication of accepted articles is usually scheduled for one of the next two issues following final acceptance. The published *Review* is mailed during the first month of the number (i.e., the January/February issue is in the mail in January).

That description of the work schedule reveals only the demanding logistical aspects of *PAR*'s editorial processes. Except for those directly involved in them, those processes remain relatively invisible. What is published in *PAR*, however, is highly visible, and that product is sometimes controversial.

Some of the differences reflect negative assessments of the product. Most simply and often, those controversies have been blamed on inherent conflicts of interests between the *Review*'s two audiences: the practitioners who dominate it as subscribers, and the academicians who dominate it as authors. A few practitioners sometimes object that many articles suffer from academic jargon which obscures a lack of relevant substance and/or methodologically weak research. A few academicians find some published articles deficient in methodology and/or theoretical foundations. From an editor's perspective, both sets of criticisms may be constructive. More high quality research and writing are needed in public administration. That is not an issue which should divide academicians from practitioners, and for most ASPA members and other *PAR* subscribers it does not. But a little name calling between practitioners and academicians has occurred throughout ASPA's history, and it requires persistent editorial attention in *PAR* to keep the focus on the real problem: a need for high-quality work.

Other controversies over *PAR*'s contents have reflected deeper currents in the field, and they have been largely positive. *PAR* was launched in what to many was P.A.'s Golden Era, when the United States turned largely to government to solve social problems. A dichotomy between politics and administration was largely accepted, certainly by the *Review*'s first editor-in-chief. Economy and efficiency were agreed-upon purposes of P.A., and the strong public executive and bureaucracy were the accepted vehicles to achieve them. With success in creation of big government, however, controversies over public policies ushered in an effectiveness era by the 1960s. By the 1970s, a new public administration *demanded* recognition. P.A. moved in diverse directions in that decade. Fundamental

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agreement persisted, however, that government should serve as the great instrumentality to solve social problems.

By the end of the 1970s, agreement on that premise of both the old P.A. of the founders and of the new P.A. of the 1960s-70s was gravely shaken. Today, private performance of public functions has many advocates in P.A. Independent sector activities are a principal part of the field. Attention is again focused on concerns of political science which were often neglected in ASPA's earlier years: distinctions between government and self-governance and a search for reasonable balances between public power and limits on it.

PAR serves as a principal publication outlet for searching inquiries into these important dimensions of P.A. It encourages careful reporting of research, experience, and conceptually disciplined analysis. The field is diverse, and varied perspectives are published. At the same time, editorial policy is guided by the values which underlie constitutional democracy and the disciplined inquiry which is fundamental to it. In that respect, the search for reasonableness continues in the *Public Administration Review.*

Editing an International Interdisciplinary Journal

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The art of editing a journal is to combine disparate authors and interests in ways that are intellectually satisfying. Editors of the *APSR* have reflected upon the difficulties of balancing the interests of different subfields in American political science, but their task is easy compared to editing the *Journal of Public Policy*. As an international journal, published by the Cambridge University Press, the *JPP* must take into account European and extra-European as well as American perspectives. As an interdisciplinary journal, it is concerned with economists, sociologists, and genuinely post-disciplinary public policy experts, as well as political scientists.

Since such a large fraction of working political scientists in the world are American, it is entirely appropriate that most leading journals are edited in the United States, and most articles are by Americans. Yet however good an article, if it is based upon a very American institution such as Congress, its generalizability can be slight. One test of a science is that its leading concepts are applicable across national boundaries.

The comparative study of public policy is particularly good at highlighting distinctive national characteristics, for what may be regarded as a constant

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within a nation can become a variable if viewed cross nationally. For example, comparing the level of taxes in America or the rate of growth in taxation in postwar America with higher levels and faster rates of growth in Europe raises questions about why America has a relatively small government.

New York publishers invariably ask about a foreign book: Does it have legs? That is, can it travel to America and still be of interest? The same question is asked in the *JPP*. We are not interested in the national setting of a piece of research, but in its international relevance. For example, a study about the National Security Council would have limited relevance to other countries, for the United States is an 'n' of one on security matters. An article about budgeting in Rhode Island (not to mention implementation in Oakland) could be internationally relevant, because of dealing with generic problems of political systems.

Ethnocentrism is a normal characteristic of people whose experience, including professional research, is concentrated upon a single country. Journals published in the Queen's English, French, German or other European lanuages bear as much witness to this as journals published in American. With an editorial board of scholars living in nine different nations, it is easy for the *JPP* to guard against this insularity. An article submitted will be refereed by scholars in two different countries and sometimes in three.

Fortunately, most good articles do have implications relevant in many different national settings. The task of an editor is not to apply mechanical criteria, of geographical representativeness, but to encourage authors to elucidate what is of wide relevance from their national case study and what qualifications might apply to generalizations based upon research in a single country.

A public policy journal is necessarily interdisciplinary, for policymakers cannot segregate the political, economic, and social dimensions of a problem as easily as universities sort social scientists into separate departments. The editorial board of the *JPP* has members from half a dozen disciplines; the dominant fields are political science and applied economics (that is, the empirical study of economic activity of concern to government).

The real test of a journal's interdisciplinary character is whether or not it normally engages in interdisciplinary refereeing. The *JPP* regularly sends out submissions to reviewers in different disciplines, since many matters of concern to public policy are 'undisciplined'. This can be satisfying to all concerned when reviewers from very different perspectives agree about an article. While any good social scientist ought to be able to spot a bad paper or appreciate a brilliant one, disciplinary differences sometimes cause reviewers to disagree. Adjudicating such disputes is the editor's equivalent of the policy-maker's need to deal with conflicting political, economic and social pressures. The object is to maintain professional standards without falling victim to disciplinary vetoes.

An editor not only guards against disciplinary narrowness but also must ask: Does this article say something of interest about public policy to people who are not specially concerned with its particular subject matter, whether health, education, or industrial relocation?

While editing a public policy journal is difficult, it is also very stimulating. Good ideas, like the problems of the contemporary world, admit no boundaries. Problems of public policy unite what academic disciplines and national political

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systems tend to keep apart. An international interdisciplinary journal is well suited to nurture a growing invisible college of scholars whose research is relevant in many countries and demonstrates that ideas, like social scientists, can travel across many boundaries.

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